
COMMENT

TWENTY-FIRST CENTURY FINANCIAL REGULATION: P2P LENDING, FINTECH, AND THE ARGUMENT FOR A SPECIAL PURPOSE FINTECH CHARTER APPROACH

JEFFREY LUTHER[†]

Online peer-to-peer (P2P) lending, once a marketplace teeming with retail investors, is now dominated by sophisticated institutional investors and banks. This seismic shift in investor base has been coupled with significant growth for the legacy P2P lenders and new entrants. A new regulatory approach is needed to grapple with these changes—one that focuses on consumer protection, as opposed to one that seeks to protect the sophisticated investors purchasing these loans. Fortunately, such an approach is readily available in the Office of the Comptroller of the Currency's fintech charter. This Comment surveys the significant changes that have occurred in the P2P lending sector over the past ten years, as well as the risks and benefits to consumers attendant to the rapid growth in this relatively new form of lending. After surveying the current and proposed regulatory approaches toward P2P lending, this Comment explains why a national fintech charter is the best approach to ensuring that consumers who rely on these loans receive the full protections guaranteed by federal law.

INTRODUCTION	1014
I. THE BUSINESS OF PEER-TO-PEER LENDING	1017
A. <i>Fundamentals</i>	1019
B. <i>The Rise of the Sophisticated Investor</i>	1020
C. <i>Risks and Benefits: The Impact of Alternative Data</i>	1023
1. Benefits to Consumers	1023
2. Risks to Consumers	1025

[†] Senior Editor, Volume 168, *University of Pennsylvania Law Review*; J.D., 2020, University of Pennsylvania Law School; B.S., 2012, University of Missouri–Kansas City. I owe my sincerest thanks to my Comment supervisor, Natasha Sarin, for her thoughtful review and assistance in writing this Comment.

II. CURRENT REGULATORY REGIME: A PRIMER	1028
A. <i>Securities Regulation by the Securities and Exchange Commission</i>	1028
B. <i>Regulation by the Federal Banking Agencies</i>	1031
C. <i>The Evolving Approach of State Regulators</i>	1034
III. A NEW REGULATORY APPROACH.....	1038
A. <i>The Status Quo of Federal Regulation Is Inadequate</i>	1039
1. Is Securities Regulation All We Need?	1040
2. Federal Regulators' Consumer-Protection Approach Is Inadequate.....	1043
3. A Deeper Look at Regulatory Sandboxes	1045
B. <i>The OCC Fintech Charter—The Best Path Forward</i>	1048
1. Background of the OCC Fintech Charter.....	1049
2. Legal Challenges Against the OCC Fintech Charter.....	1050
3. Policy Challenges to the OCC Fintech Charter	1054
4. Fintech Chartering—A Twenty-First Century Solution.....	1055
CONCLUSION.....	1059

INTRODUCTION

Peer-to-peer (P2P) lending is one of the fastest growing and most significant segments of the broad area of financial technology (fintech).¹ Today, P2P lenders account for 36% of all unsecured consumer loans made in the United States.² Attendant to this growth has been an enormous shift in the business model of P2P lending. The investor base of P2P lenders, once comprised primarily of individual retail investors, is now dominated by sophisticated institutional investors and banks.³ Despite this seismic shift, the regulatory approach to P2P lending remains one focused on the investor, with little appreciation for the risks this area of lending poses to consumers. The current approach of providing the greatest protection to the investor class best able to fend for itself is irrational and in need of significant reform. A new approach is needed, one that ensures compliance with consumer protection laws and learns and adapts to the unique risks posed by this innovative area of lending.

¹ Online P2P lending, which is the focus of this Comment, “can be defined as any transaction arranged using the Internet in which one or more individuals lend money to one or more other individuals.” Eric C. Chaffee & Geoffrey C. Rapp, *Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd–Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry*, 69 WASH. & LEE L. REV. 485, 491 (2012). The key distinction between P2P lending and traditional lending is that “individuals, rather than institutions, stand on both sides of the transaction.” *Id.* at 491–92.

² See *infra* note 26 and accompanying text.

³ See *infra* notes 28–41 and accompanying text (discussing the shift toward sophisticated investors as the dominant purchasers of P2P lending notes).

Prior to its current form, P2P lending seemed like a technology that could fundamentally shift the paradigm of lending.⁴ Many saw it as a means to finally disintermediate lending and borrowing, an exciting prospect in the postfinancial crisis world. In light of this potential, a surprisingly robust academic debate emerged from 2010–2013 over the appropriate regulatory structure for this relatively niche area of lending.⁵ Some of the earliest and most vocal participants in this debate directed their greatest criticism at the U.S. Securities and Exchange Commission (SEC) and its decision to regulate this lending under the securities laws.⁶ Rather, the newly created Consumer Financial Protection Bureau (CFPB) seemed to be the regulator of choice, for both industry and academics. The overarching concern for all, though, was the idea that this new technology must be fostered, rather than extinguished, by zealous regulators.

But 2020 is a very different year than 2013. Despite some indications that the CFPB or the Federal Deposit Insurance Corporation (FDIC) might step in to directly regulate P2P lending, these agencies never did so, and the SEC remains the only active federal player in the field. However, the business of P2P lending has changed significantly and barely resembles its original promise. Today, the investor base of these platforms is almost entirely dominated by sophisticated institutional investors and banks. Long gone are the days of mom-and-pop retail investors seeking out these platforms for investment alternatives. Some things have stayed the same. The innovative use of alternative data by these P2P lenders has been a far more consistent thread in this field and has shown itself to be a promising new form of underwriting. However, the use of this data, while originally deployed on a large scale by P2P lenders, no longer remains unique to them.

Not only has the business model of P2P lenders changed dramatically but so to have the laws that regulate these entities. The securities laws saw significant change in the form of the Jumpstart Our Business Startups Act (JOBS Act), which offered regulatory relief in securities laws compliance.⁷ Federal and state regulators have also sought to build regulatory structures

⁴ See, e.g., Chaffee & Rapp, *supra* note 1, at 501 (“Online P2P lending is hot. The Harvard Business Review called it a ‘breakthrough idea of 2009.’”); John Sviokla, *Forget Citibank—Borrow from Bob*, in *Breakthrough Ideas for 2009*, HARV. BUS. REV. (Feb. 2009), <https://hbr.org/2009/02/breakthrough-ideas-for-2009> [<https://perma.cc/J9DK-3X4C>] (“The financial crisis will trigger an increase in peer-to-peer financing. Already Lending Club and other organizations are demonstrating how novel approaches to credit scoring . . . can reduce risk.”); Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 452 (2011) (“P2P lending hints at a world with the benefits of intermediation but none of the costs.”).

⁵ See *infra* note 12 and accompanying text.

⁶ See *infra* note 138 and accompanying text.

⁷ See *infra* notes 86–92 and accompanying text (discussing regulatory relief from the securities laws under the JOBS Act through Rule 506(c) private placements).

around fintech entities generally in the form of new and innovative banking charters and regulatory “sandboxes,” which are intended to provide a variety of regulatory relief. Additionally, as fintech companies have grown and become more established market participants, particularly in the lending area, these entities have become more comfortable with the traditional financial regulatory regime. Indeed, the largest P2P lender in the United States, LendingClub, very recently announced a proposed agreement to acquire a federally chartered bank for the express purpose of creating a direct relationship with federal regulators and obtaining access to insured deposits.⁸

Despite these changes, the actual mandatory regulatory regime governing P2P lenders has remained largely unchanged since 2013. Some recent academic literature has sought to grapple with these changes and the effect of these changes on the regulatory regime.⁹ In contrast to other scholarship in this area, this Comment argues that the best regulatory approach going forward is one based around fintech chartering. It describes the changes that have occurred in P2P lending and pragmatically assesses how the regulatory regime around P2P lending should look in light of these changes. Concerning investor-side regulation of P2P lending, this Comment takes the position that early SEC regulation of P2P lending notes had a detrimental effect on the industry. However, this negative impact has since been strongly mitigated by the new private placement rules under the JOBS Act, thereby obviating many of the critiques leveled against SEC regulation by early legal commentators in this area. Concerning borrower-side regulation of P2P lending, this Comment argues that P2P lending, as with all lending, presents significant consumer protection risks. Despite this, regulation in this area remains wholly underprotective. This Comment argues that the most feasible remedy to this problem is the Office of the Comptroller of the Currency’s (OCC) fintech charter.

Part I of this Comment provides an overview of P2P lending. This Part discusses the business model of P2P lending and pays particular attention to the emergence of institutional investors in this area. Part I also includes a discussion of the consumer benefits and risks associated with P2P lending.

Part II examines in greater depth the current regulatory regime around P2P lending. This Part first discusses how P2P lending notes are regulated under the securities laws. Next, this Part examines how P2P lenders are indirectly regulated by the federal banking agencies through the lenders’

⁸ Press Release, LendingClub, LendingClub Announces Acquisition of Radius Bank (Feb. 18, 2020), <https://ir.lendingclub.com/file/Index?KeyFile=402858346> [<https://perma.cc/65V2-ULDN>]. Notably, this proposed acquisition remains subject to approval by federal regulators. *Id.*

⁹ See generally William S. Warren, *The Frontiers of Peer-to-Peer Lending: Thinking About a New Regulatory Approach*, 14 DUKE L. & TECH. REV. 298 (2016) (discussing the systemic risks posed by the increased presence of institutional investors in P2P marketplaces).

relationships with state and federally chartered banks. This Part explains how this indirect regulation does ensure a certain level of compliance with federal lending laws but is substantially less comprehensive than the direct oversight performed on chartered institutions. Finally, this Part briefly discusses state oversight of P2P lenders, with a focus on the integrated regulatory regime being pushed by the Conference of State Bank Supervisors (CSBS).

Part III argues that the OCC fintech charter represents the best regulatory option for P2P lenders. This Part discusses and rejects the argument that regulation under the securities laws alone is sufficient. This Part further argues that the current combination of federal regulation of P2P lenders as third-party service providers and state-level regulation is underprotective and inefficient. This Part then provides an overview of the OCC fintech charter and recent legal challenges to the charter. This Part concludes with a normative argument that the OCC fintech charter represents the best available option for consumers, P2P lenders, and the broader U.S. economy.

I. THE BUSINESS OF PEER-TO-PEER LENDING

P2P lending¹⁰ has gained a significant portion of the consumer lending market in a very short time and this growth is anticipated to continue.¹¹ Today, consumer P2P lending is dominated by LendingClub and Prosper, though Upstart is a newer entrant that has grown rapidly. P2P lending has also expanded over the past five years or so to encompass small business lending, auto title lending, and student loans. The business of P2P lending, and the attendant regulation of this business, was of particular focus in law journals between 2010 and 2013.¹² However, while the overall structure of P2P

¹⁰ This Comment sometimes uses the alternative term “marketplace lending.” Technically, marketplace lending is a broader category of lending of which P2P lending is a part. It refers to “nonbank financial platforms that leverage technology to reach potential borrowers, evaluate creditworthiness, and facilitate loans.” *Fintech Series: Marketplace Lending*, FED. TRADE COMMISSION, <https://www.ftc.gov/news-events/events-calendar/2016/06/fintech-series-marketplace-lending> [https://perma.cc/KX7L-F4NN] (last visited Nov. 3, 2019). Therefore, it includes online, nonbank lenders that do not have a P2P component. *See id.* Because this Comment is focused on the consumer protection risks related to P2P lending, much of its normative recommendations are easily transferrable to regulating marketplace lending broadly.

¹¹ *See* PRICEWATERHOUSECOOPERS LLP, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CONSUMER LENDING INDUSTRY 1 (2015), <https://www.pwc.com/us/en/consumer-finance/publications/assets/peer-to-peer-lending.pdf> [https://perma.cc/7NLR-FH PD] (stating that P2P platforms issued only \$5.5 billion in loans in 2014 and predicting that the P2P lending market could reach \$150 billion in loans by 2025).

¹² *See generally, e.g.*, Chaffee & Rapp, *supra* note 1 (arguing for a multiagency regulatory approach to online P2P lending); Paul Slattey, *Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative*, 30 YALE J. ON REG. 233 (2013) (arguing that P2P online lending should be exempted from SEC regulation due to compliance costs, barriers to entry,

lending as a two-sided platform with investors and borrowers on each side remains, the business model of P2P lending has changed significantly since that time. In its earliest iterations, P2P lending often relied on “soft information” in making credit decisions.¹³ This feature is largely nonexistent today, though the use of “alternative data” continues.¹⁴ Additionally, while the original models of P2P lending centered around small individual investors, the investing side of P2P lending is increasingly dominated by large, sophisticated institutional investors and banks.

These changes significantly altered the risk profile of P2P lending. The increasing presence of large, sophisticated investors in this area reduces the risk of investor harm as these parties are better able to fend for themselves. At the same time, the increased presence of these sophisticated parties and the decreased reliance on “soft” factors results in a P2P lending model that is substantially similar to more traditional consumer lending. P2P lending also poses some unique risks to consumers. For example, the use of nontraditional data in lending decisions presents risks of consumer harm that current law does not address. While acknowledging these risks, the passage of time from 2013 has allowed greater empirical research on the broader effects of P2P lending. Much of this research indicates that P2P lending has potentially significant consumer benefits. An analysis of these risks and benefits serves as an important foundation in addressing the proper regulatory regime for this area of lending.

This Part first provides a brief background on the business of P2P lending. It then describes the general shift away from small retail investors toward larger and more sophisticated investors, as well as the increasingly complex products offered by P2P lenders. Following this discussion, this Part looks to the benefits and risks posed by P2P lending. The analysis of benefits and risks is informed both by empirical studies and risks inherent in the evolving business model of these lenders.

and consumer risks); Verstein, *supra* note 4 (arguing for CFPB regulation over SEC regulation for P2P lending).

¹³ “Soft information” typically means data beyond that found in a credit report, such as “non-standardized answers to questions . . . or even pictures, which were an important part of the ‘peer-to-peer’ aspect that was initially supported.” Boris Vallée & Yao Zeng, *Marketplace Lending: A New Banking Paradigm?*, 32 REV. FIN. STUD. 1939, 1945 n.8 (2019).

¹⁴ See Julapa Jagtiani & Catharine Lemieux, *The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform 2* (Fed. Reserve Bank of Phila., Working Paper No. 18-15, 2019) (“[O]ver the years, alternative sources of information have been increasingly used by fintech lenders to evaluate credit applications.”). “Alternative data” generally means data other than that typically used by traditional lenders, such as FICO scores and debt-to-income ratios. Alternative data can include utility payments, rent payments, education, and other internet footprint information. *Id.* at 2-3. This data is often used by these lenders in conjunction with machine learning and artificial intelligence to make credit decisions. *Id.* at 1.

A. Fundamentals

P2P lending, at its most basic level, is any transaction in which individuals lend and borrow small amounts of money from other individuals.¹⁵ As early as 2005, online platforms began appearing to facilitate these transactions.¹⁶ These online platforms disrupted traditional consumer lending through disintermediation. Before marketplace lending, most consumers seeking small dollar loans would obtain such loans through a financial institution. The financial institution funded these loans with deposits taken from the community, and the institution earned its money off the spread between low-yielding deposits and higher-yielding loans. P2P lenders offered the opportunity for consumers to go directly to the community to obtain their loans. As originally conceived, this model would mean higher rates of return for investors, lower costs of borrowing for consumers, and a reduction in transaction costs that would accrue to both borrowers and lenders rather than banks.

Although the way P2P lenders originated loans during the early stages of this technology varied in significant and interesting ways,¹⁷ all P2P lenders now operate in essentially the same manner. Borrowers apply for a loan through the P2P lender's online platform. Both Prosper and LendingClub utilize proprietary algorithms and models that analyze borrower risk based on alternative information including "behavioral data, transactional data and employment information to supplement traditional risk assessment tools, such as FICO scores, to assess a borrower's risk profile."¹⁸ This data is utilized to assign loan grades, loan amounts, and interest rates, which are then listed on the P2P lender's investor marketplace.¹⁹ Once the P2P lender receives sufficient investor commitments, it originates the loan through an issuing bank (both Prosper and LendingClub most often use WebBank) and issues the loan to the borrower.²⁰ The P2P lender then uses the funds committed by investors

¹⁵ Chaffee & Rapp, *supra* note 1, at 491.

¹⁶ *See id.* at 492 (noting that the earliest online P2P lenders started in Europe in 2005).

¹⁷ For background on the original business models of these lenders, see Jefferson Duarte et al., *Trust and Credit: The Role of Appearance in Peer-to-Peer Lending*, 25 REV. FIN. STUD. 2455, 2458-59 (2012) (discussing the auction process originally used by Prosper); Mingfeng Lin et al., *Judging Borrowers by the Company They Keep: Friendship Networks and Information Asymmetry in Online Peer-to-Peer Lending*, 59 MGMT. SCI. 17, 18 (2013) (discussing the role of lender "friendships" in the early P2P lending origination process).

¹⁸ LendingClub Corp., Annual Report (Form 10-K) 9 (Feb. 20, 2019) [hereinafter LendingClub 10-K]; *accord* Prosper Marketplace, Inc. & Prosper Funding LLC, Annual Report (Form 10-K) 6 (Mar. 28, 2019) [hereinafter Prosper 10-K].

¹⁹ LendingClub 10-K, *supra* note 18, at 5-10; Prosper 10-K, *supra* note 18, at 6.

²⁰ LendingClub 10-K, *supra* note 18, at 8; Prosper 10-K, *supra* note 18, at 7-8. In light of LendingClub's recent proposed acquisition of a federally chartered bank, it is likely that it will no longer need to rely on an issuing bank. Press Release, LendingClub, *supra* note 8. However, it is difficult to anticipate how the LendingClub business model will change until that acquisition is completed.

to purchase the loan back from the issuing bank.²¹ Originally, P2P lenders provided investors with an indirect security interest in the loan payments.²² However, the SEC disallowed P2P lenders from providing such a security interest.²³ As a result, notes purchased on a P2P platform are not insured and are generally unsecured.²⁴

Investors have flocked to these loans. P2P lending has grown rapidly and is now big business. In 2010, fintech companies in the marketplace lending area originated less than 1% of consumer loans in the United States.²⁵ By the end of 2018, marketplace lenders, with P2P lenders driving much of the growth, originated 38% of all loans in the \$138 billion U.S. consumer debt market.²⁶ And there is no reason to believe that this growth will slow down. A PwC analysis estimated that the P2P lending market alone could reach \$150 billion or more by 2025.²⁷

B. *The Rise of the Sophisticated Investor*

In addition to transforming the market for consumer loans, the business model for P2P lending has changed significantly itself. Large investors have taken notice of the rapid growth and innovative underwriting practices of these lenders. A LendingClub memo showed that only 2% of its standard program loans went to institutional investors in 2012 and that retail investors were the predominant parties funding loans in 2010 and 2011.²⁸ In stark contrast, during 2018, self-directed retail investors accounted for less than 10% of loan investments on LendingClub.²⁹ Banks, institutional investors, third-party managed funds, and LendingClub itself accounted for all other

²¹ LendingClub 10-K, *supra* note 18, at 8; Prosper 10-K, *supra* note 18, at 8.

²² Slattery, *supra* note 12, at 251.

²³ See *id.* at 259 (discussing how the SEC disallowed P2P lenders from providing security interests in the notes because it was contrary to the Rule 415 requirement that the P2P lenders be the sole issuer of the notes).

²⁴ LendingClub 10-K, *supra* note 18, at 28.

²⁵ Hannah Levitt, *Personal Loans Surge to Record High*, BLOOMBERG (July 3, 2018), <https://www.bloomberg.com/news/articles/2018-07-03/personal-loans-surge-to-a-record-as-fintech-firms-lead-the-way> [<https://perma.cc/TJE4-WV6F>].

²⁶ See *Fintech Continues to Drive Personal Loan Growth*, TRANSUNION (Feb. 21, 2019), <https://newsroom.transunion.com/fintechs-continue-to-drive-personal-loans-to-record-levels/> [<https://perma.cc/ZR9N-62GA>] (reporting that personal loan balances increased to \$138 billion and “[f]intech loans now comprise 38% of all unsecured personal loan balances”); see also Levitt, *supra* note 25 (“Web-based firms like LendingClub, Prosper Marketplace Inc. and closely held Social Finance Inc. are driving the expansion of personal loans.”).

²⁷ PRICEWATERHOUSECOOPERS LLP, *supra* note 11, at 1.

²⁸ Benjamin Lo, *It Ain't Broke: The Case for Continued SEC Regulation of P2P Lending*, 6 HARV. BUS. L. REV. ONLINE 87, 102 n.73 (2016) (citation omitted).

²⁹ LendingClub 10-K, *supra* note 18, at 72.

purchases.³⁰ This trend is even more dramatic for Prosper, where 94% of its loans are funded through its “whole loan channel,” which is only available to accredited investors, many of which are institutional investors and banks.³¹ Additionally, smaller P2P lenders like Upstart and Funding Circle make their loans only available to accredited investors in the first place.³²

Some in the legal academic literature have acknowledged this trend among P2P lenders along with its accompanying risks.³³ However, little attention has been paid to how the increased presence of institutional investors should alter the regulatory approach to P2P lenders. I argue that the result of this trend is that these platforms, once dominated by small retail investors, are becoming more enmeshed with and similar to traditional financial intermediaries.

The influence of institutional and other sophisticated investors in P2P lending is also reflected in these lenders’ increased focus on more complex financial instruments. LendingClub, for example, now securitizes a portion of its unsecured loans into asset-backed securitizations.³⁴ It also developed a financial instrument, called CLUB certificates, which are targeted specifically at institutional investors and are collateralized passthrough securities that are exempt from securities registration as private placements.³⁵ This trend toward complex securitized instruments that are far beyond the investing expertise of the average retail investor further signals the trend of the P2P lending industry toward traditional financial intermediaries.

³⁰ The exact breakdown for Q4 2018 is as follows: banks acquired 41%, institutional investors acquired 19%, third-party managed funds acquired 16%, and LendingClub acquired the remaining 18%. *Id.* Self-directed individual investors acquired only 6% of loans originated in that quarter. *Id.*

³¹ Prosper 10-K, *supra* note 18, at 6, F-46. An accredited investor is generally, though not always, a person with net worth greater than \$1 million (excluding net worth associated with a personal residence) or a person with individual income over \$200,000 or joint income over \$300,000. 17 C.F.R. § 230.501(a)(5)–(6) (2019). For additional categories of accredited investors, see 17 C.F.R. § 230.501(a).

³² See *Frequently Asked Questions*, FUNDING CIRCLE, <https://www.fundingcircle.com/us/invest/faq/> [<https://perma.cc/ZC2K-8BZV>] (last visited Apr. 10, 2019) (stating that Funding Circle notes are only available to accredited investors); *How Do I Become an Investor?*, UPSTART, <https://investorhelp.upstart.com/7973-investing-on-upstart/83780-how-do-i-become-an-investor> [<https://perma.cc/YJC5-2R2Y>] (last visited Apr. 10, 2019) (stating that individuals must confirm that they are accredited investors to invest through Upstart).

³³ Much of the existing writing on the role of institutional investors in P2P lending continues to focus on systemic risks rather than consumer protection risks. See, e.g., Jacob Gregory Shulman, Note, *Regulating Online Marketplace Lending: To be a Bank or Not to be a Bank?*, 44 RUTGERS COMPUTER & TECH. L. J. 163, 165 (2018) (explaining that the article assesses concerns of small and medium-sized enterprises in marketplace lending); Warren, *supra* note 9, at 309 (arguing that P2P lending “is threatened whenever the pool of potential lenders is restricted to those who qualify as accredited investors” and that growth in secondary markets and securitization for P2P loans re-introduces “dangers, such as moral hazard or risk transmission, that financial disintermediation promises to address”). Therefore, this Comment does not address these issues in depth.

³⁴ LendingClub 10-K, *supra* note 18, at 7.

³⁵ *Id.* at 41.

There are many reasons why large sophisticated investors are pushing out smaller retail investors. Certain provisions of the securities laws exempting onerous registration requirements likely drove the decision of newer P2P lenders like Funding Circle and Upstart to only offer investments to accredited investors in the first place.³⁶ For the legacy P2P lenders like LendingClub and Prosper, the story is more complex. A survey of large institutional investors conducted in 2017 indicated that their increased investments were driven primarily by diversification, the higher yields on these loans, and a desire to access consumer or small business credit.³⁷

But while a fair amount of blog posts, articles, and studies have been devoted to the increasing role of institutional investors in P2P lending, relatively little has been written about the role of traditional banks in this area. Banks purchased 41% of all LendingClub loan originations during Q4 2018 and are consistently among the highest acquirors of LendingClub's loans.³⁸ Similarly detailed information is not available for Prosper, but Prosper's annual report does indicate that the company is dependent in part on banks as a third-party funding source for its loans.³⁹

A plausible, albeit speculative, explanation for this could be that banks increasingly see these P2P lending platforms as a more efficient way to build their consumer loan portfolios in lieu of originating these loans independently. Another possible explanation is that P2P lending is simply a form of "regulatory arbitrage," allowing traditional lenders, like banks, to participate in traditional lending activities while avoiding the more costly and stringent regulations to which they would otherwise be subject.⁴⁰ Indeed, Hilary Allen writes that one study by Greg Buchak and others "concluded that the desire to avoid banking regulation was primarily responsible for the rise of nonbank consumer lending."⁴¹ Regardless of the reason, the manner in which P2P lending is increasingly reliant on the traditional banking sector further belies its original promise as the "killer app" for banking disintermediation.

³⁶ See *infra* notes 145–148 and accompanying text (discussing Rule 506(c), which exempts issuers of securities from registration as long as the securities are only sold to accredited investors).

³⁷ *Why Institutional Investors Are Turning to Marketplace Loans*, LENDINGCLUB (Dec. 10, 2018), <https://blog.lendingclub.com/institutional-insights-into-marketplace-lending/> [<https://perma.cc/8BQK-B47G>] (citation omitted). The survey also found that a majority of investors believe that P2P lending will be a "significant player in the financial system in the next 10 years." *Id.*

³⁸ LendingClub 10-K, *supra* note 18, at 72.

³⁹ Prosper 10-K, *supra* note 18, at F-46.

⁴⁰ See Hilary J. Allen, *Regulatory Sandboxes*, 87 GEO. WASH. L. REV. 579, 609 (2019) (outlining concerns that some innovations "are primarily designed to recreate functions already performed by regulated financial intermediaries while avoiding the relevant regulation (known as regulatory arbitrage)").

⁴¹ *Id.* (citation omitted).

C. Risks and Benefits: The Impact of Alternative Data

The main driver of both the unique risks and benefits posed by P2P lending is its heavy reliance on alternative data. It appears that P2P lenders' expansion of credit to underserved communities is strongly correlated with the use of alternative data. At the same time, there are serious concerns that this data could be used to further discriminatory practices. Apart from alternative data, P2P lending, like all lending, poses other, more traditional risks to consumers. These risks can come in many forms, from usurious interest rates to hidden fees to other abusive practices like redlining. Overall, the degree to which consumers have benefited from P2P lending and its innovative underwriting practices remains an open question. Some studies indicate that borrowers that use P2P loans receive similar, or even higher, interest rates relative to traditional lenders.⁴² Other empirical research studies conducted on this topic indicate that borrowers are able to obtain lower overall rates relative to traditional lenders.⁴³ What is clear, though, is that consumers appreciate these lenders, judging by the growth in this market.

This Section proceeds by discussing the benefits of P2P lending—specifically, the clear inroads P2P lenders have made in improving access to credit. This Section then discusses the risks of P2P lending, focusing mostly on the risks associated with alternative data in P2P lending.

1. Benefits to Consumers

One of the most important and clearly established benefits of P2P lenders has been increasing access to credit for traditionally underserved communities.⁴⁴ Many of these individuals do not have access to credit because of their lack of credit history.⁴⁵ Alternative data, by using other metrics of an individual's creditworthiness, has the potential to dramatically expand access to credit. Banking regulators have recognized this potential. In a 2016 interagency

⁴² See Robert M. Adams, *Do Marketplace Lending Platforms Offer Lower Rates to Consumers?*, FEDS NOTES (Oct. 22, 2018), <https://www.federalreserve.gov/econres/notes/feds-notes/do-marketplace-lending-platforms-offer-lower-rates-to-consumers-20181022.htm> [<https://perma.cc/E4BV-UUBA>] (summarizing several studies that reveal similar or higher rates in residential lending markets, German financial markets, and small business loans).

⁴³ See, e.g., *id.* ("This note provides evidence that credit card borrowers may receive potentially significant interest rate reductions as a result of obtaining loans from online P2P platforms."); see also Jagtiani & Lemieux, *supra* note 14, at 18, 26 ("We find that the use of nontraditional information from alternative data sources has allowed consumers with fewer or inaccurate credit records (based on FICO scores) to have access to credit.").

⁴⁴ See *infra* notes 52–55 and accompanying text (discussing how a study of LendingClub's consumer lending activity showed that the P2P lender was able to offer lower-priced credit to underserved borrowers).

⁴⁵ See *infra* notes 47–50 (discussing the challenges individuals with a lack of a credit score face in obtaining credit from traditional lenders).

guidance, the CFPB noted that this “innovative and flexible practice” could help address “the credit needs of low- or moderate-income individuals” and also stated that these practices would be considered in evaluating a bank’s compliance with the Community Reinvestment Act (CRA).⁴⁶

The potential for P2P lending to expand access to credit to low-income and minority individuals could help solve one of the most vexing and troublesome aspects of U.S. credit markets. A 2015 study by the CFPB evaluated the demographics of individuals that lack any credit history whatsoever, who the study deemed “credit invisible.”⁴⁷ The report also examined individuals who have a credit history but one that contains too little information to generate a score.⁴⁸ Generally, individuals who are credit invisible or lack a credit score (unscored individuals) are much less likely to obtain credit from a lender.⁴⁹ The most revealing component of this report is the demographic breakdown of credit invisible and unscored individuals:

Almost 30 percent of consumers in low-income neighborhoods are credit invisible and an additional 15 percent have unscored records. These percentages are notably lower in higher-income neighborhoods. For example, in upper-income neighborhoods, only 4 percent of adults are credit invisible and another 5 percent have unscored credit records. . . . Blacks and Hispanics are more likely than Whites or Asians to be credit invisible or to have unscored credit records These differences are observed across all age groups, suggesting that these differences materialize early in the adult lives of these consumers and persist thereafter.⁵⁰

Of particular concern is that these demographic imbalances persist despite the fact that lawmakers and regulators have spent decades attempting to remediate these issues. While major legislation like the Community Reinvestment Act of 1977⁵¹ has undoubtedly prevented some of the most egregious discriminatory lending practices, the continued existence of the

⁴⁶ CONSUMER FIN. PROT. BUREAU, REQUEST FOR INFORMATION REGARDING USE OF ALTERNATIVE DATA AND MODELING TECHNIQUES IN THE CREDIT PROCESS 12-13 (2017), https://files.consumerfinance.gov/f/documents/20170214_cfpb_Alt-Data-RFI.pdf [https://perma.cc/4W6D-L8ZK] (citation omitted).

⁴⁷ CFPB OFFICE OF RESEARCH, DATA POINT: CREDIT INVISIBLES 4 (2015), https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf [https://perma.cc/X764-WC35].

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.* at 6.

⁵¹ Pub. L. No. 95-128, §§ 801-806, 91 Stat. 1111, 1147-48. The Act was enacted in 1977 “to prevent redlining and to encourage banks and savings associations . . . to help meet the credit needs of . . . low- and moderate-income neighborhoods.” OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMMUNITY REINVESTMENT ACT FACT SHEET 1 (2014), <https://www.occ.gov/topics/community-affairs/publications/fact-sheets/pub-fact-sheet-cra-reinvestment-act-mar-2014.pdf> [https://perma.cc/KKS4-QLLV].

problem indicates greater structural issues with the credit markets serving these communities.

P2P lenders show early signs of remediating these structural issues. While empirical research on this topic is inherently limited given the relatively recent emergence of P2P lending, the research that has been performed is promising. A 2017 study of LendingClub's consumer lending activity indicated that consumers who might otherwise be denied credit from traditional lenders based on their credit history were able to obtain lower-priced credit from LendingClub.⁵² This study also found that LendingClub was able to penetrate underserved credit markets, particularly areas experiencing a decline in banking branches and highly populated areas.⁵³ Notably, bank branch closures have a disproportionate effect on minority communities.⁵⁴ A separate empirical analysis indicates that state laws limiting access to marketplace loans broadly had the effect of reducing credit availability for low-income individuals, resulting in a "persistent rise in personal bankruptcies."⁵⁵ Overall, these studies constitute promising evidence that P2P lenders are succeeding at increasing credit availability where traditional lenders have failed.

2. Risks to Consumers

P2P lending today is substantially the same as traditional lending.⁵⁶ As such, the risks of P2P lending are substantially the same as those associated with traditional lending. As noted by Paul Slattery in an early piece on P2P lending, "All borrowers [face the] risk [of] misleading loan terms, discriminatory or predatory credit determinations, and abusive collection

⁵² Jagtiani & Lemieux, *supra* note 14, at 26.

⁵³ See Julapa Jagtiani & Catharine Lemieux, *Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?* 14 (Fed. Reserve Bank of Phila., Working Paper No. 18-13, 2018) ("We presented evidence that fintech lenders can fill credit gaps in areas where bank offices may be less available and the local economy may be more challenging."); Olena Havrylchyk et al., *What Drives the Expansion of the Peer-to-Peer Lending?* 6 (LabEx ReFi, Policy Brief 2017-02, 2017), http://www.labex-refi.com/wp-content/uploads/2018/02/2017_02_labex_refi_Policy_Brief_Mariotto_Verdier_havrylchyk_rahim.pdf [<https://perma.cc/RY63-AKME>] ("P2P lending platforms have made inroads into counties that are underserved by banks" and "counties with higher population density . . . experience higher growth of P2P lending.").

⁵⁴ See JASON RICHARDSON ET AL., NAT'L CMTY. REINVESTMENT COAL., *BANK BRANCH CLOSURES FROM 2008–2016: UNEQUAL IMPACT IN AMERICA'S HEARTLAND* 3 (2017), https://ncrc.org/wp-content/uploads/2017/05/NCRC_Branch_Deserts_Research_Memo_050517_2.pdf [<https://perma.cc/5N94-QWZB>] ("Banking deserts disproportionately impacted minorities, with 25% of all rural closures in majority-minority census tracts.").

⁵⁵ Piotr Danisewicz & Ilaf Elard, *The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy* 1 (May 15, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3208908 [<https://perma.cc/W7HZ-BKEX>].

⁵⁶ See *supra* notes 28–32 and accompanying text (discussing the increased reliance of P2P lenders on traditional financial institutions).

practices.”⁵⁷ Furthermore, P2P lenders, like traditional banks and many other technology companies, collect significant amounts of sensitive customer information that is at risk in the event of a data breach.⁵⁸ None of these risks are unique to P2P lenders and much of the current bank regulatory regime is structured around reducing these risks.

One aspect of the P2P lending model, however, does pose a unique risk: the use of alternative data. There are two main risks that will be the focus of this subsection. First, analysis of alternative data used in P2P lenders’ algorithms indicates that the underlying data may contain significant inaccuracies. These inaccuracies can lead to improper credit denials or excessive interest rates for borrowers. Second, because the algorithms used to assess alternative data are proprietary, it is difficult to determine whether the algorithms result in discriminatory lending practices. Both of these risks raise the potential for violations of federal lending laws like the Fair Credit Reporting Act, the CRA, and the Equal Credit Opportunity Act.

The potential for inaccuracies in the alternative data used in P2P lending credit decisions can significantly undermine the P2P lending model. Inaccuracies in traditional credit reporting are well known—a 2012 study by the Federal Trade Commission found that 26% of consumers had an error on their credit report and that 5% of consumers had an error serious enough to affect their credit score by more than twenty-five points.⁵⁹ Unsurprisingly, alternative data also suffers from similar inaccuracies. A 2014 study by the National Consumer Law Center (NCLC) found that reports from alternative data aggregators⁶⁰ contained significant errors, such as incorrect addresses, added or omitted family members, and added or omitted social media profiles.⁶¹ The existence of these errors is of concern because this data is a key component of the P2P lending underwriting process. Therefore, errors could result in higher interest rates or denials of credit. This is concerning for credit invisible and unscored individuals given their lack of credit metrics used in the traditional loan underwriting process. These errors could undermine a key

⁵⁷ Slattery, *supra* note 12, at 245 (citing U.S. GOV’T ACCOUNTABILITY OFF., GAO-11-613, PERSON-TO-PERSON LENDING 25 (2010)).

⁵⁸ LendingClub 10-K, *supra* note 18, at 33-34; Prosper 10-K, *supra* note 18, at 29.

⁵⁹ FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, at i (2012).

⁶⁰ The report reviewed information obtained from five big data companies that aggregate a variety of alternative information on consumers. PERSIS YU & JILLIAN MCCLAUGHLIN, NAT’L CONSUMER LAW CTR., BIG DATA: A BIG DISAPPOINTMENT FOR SCORING CONSUMER CREDIT 15-16 (2014). The five companies were Acxiom, eBureau, ID Analytics, Intelius, and Spokeo. *Id.*

⁶¹ See *id.* at 18 (listing the types of inaccuracies found in reports purchased from Spokeo and Intelius).

potential benefit of alternative data: its ability to penetrate traditionally underserved populations.⁶²

The potential presence of inaccurate information is further exacerbated by the fact that the consumer may not even know that inaccuracies exist. As noted by the NCLC, “Most of the information collected is gathered from the consumer without his or her knowledge.”⁶³ This makes it exceedingly difficult for the consumer to dispute potentially inaccurate information and for users of alternative data to assess the validity of such disputes.

Reliance on proprietary algorithms and data also increases the risk of illegal discrimination. As identified by the CFPB, “Machine learning algorithms that sift through vast amounts of data could unearth variables, or clusters of variables, that predict the consumer’s likelihood of default . . . but are also highly correlated with race, ethnicity, sex, or some other basis protected by law.”⁶⁴ This could lead not only to “disparate impact on the part of a well-intentioned lender” but also provide a means for lenders to engage in intentional discriminatory practices under the guise of alternative data and artificial intelligence.⁶⁵ The NCLC further identified some of the potentially discriminatory effects attendant to the use of alternative data. For example, a report from Transunion highlighted the use of zip codes as a proxy for a consumer’s ability to repay, stating that alternative data is “helpful to [debt] collectors because it can identify local credit conditions clustered around common demographics.”⁶⁶ The Transunion report went further to state that the use of alternative data for these purposes is especially helpful for consumers with minimal credit history.⁶⁷

Alternative data and underwriting algorithms raise complex issues. This innovative form of underwriting has the potential to expand access to credit to individuals often overlooked by traditional financial institutions. At the same time, alternative data creates the risk of suboptimal credit decisions driven by inaccurate data and outright illegal discrimination.⁶⁸ These potential risks, balanced against some of the evident benefits, must be factored into any discussion of the appropriate regulatory approach to P2P lending. But before providing normative recommendations for a P2P lending regulatory regime, it is necessary to first evaluate the current regulatory state.

⁶² See *supra* notes 47–55 and accompanying text.

⁶³ YU & MCLAUGHLIN, *supra* note 60, at 24.

⁶⁴ CONSUMER FIN. PROT. BUREAU, *supra* note 46, at 19.

⁶⁵ *Id.*

⁶⁶ YU & MCLAUGHLIN, *supra* note 60, at 28 (citation omitted).

⁶⁷ *Id.*

⁶⁸ See CONSUMER FIN. PROT. BUREAU, *supra* note 46, at 19 (“Alternative data and modeling techniques could . . . result in illegal discrimination.”).

II. CURRENT REGULATORY REGIME: A PRIMER

The regulation of financial services is complex, and almost all participants in the financial services market are subject to a patchwork of municipal, state, and federal regulations. The regulation of P2P lenders is no exception. However, unlike many other new fintech companies and legacy financial industry participants, the unique business model of P2P lenders has resulted in particularly onerous compliance requirements with federal securities laws. In addition to this, P2P lenders remain subject to the panoply of federal lending regulations covering debt collection, lending disclosures, and many other areas, as well as state laws that often either overlap with these federal regulations or impose more stringent requirements.

A full and complete discussion of the myriad regulations facing P2P lenders is beyond the scope of this Comment and has already been ably described in a comprehensive industry overview.⁶⁹ Instead, this Part will discuss the two primary ways in which P2P lenders are currently regulated on the federal level: registration requirements under the federal securities laws and indirect supervision by the federal banking agencies. It will also highlight new state-based approaches to regulating fintech firms—including P2P lenders—which include an effort by the CSBS to develop an integrated fifty-state licensing and supervisory structure. This Part then provides an overview of new “regulatory sandboxes” and assesses whether sandboxes are an appropriate approach toward P2P lenders.

A. Securities Regulation by the Securities and Exchange Commission

P2P lenders largely avoided direct regulation by the federal government in the early days of operation. This changed when the SEC intervened into the market in 2008 with a cease-and-desist order to Prosper.⁷⁰ Both LendingClub and Prosper were ultimately successful in complying with the securities laws.⁷¹

⁶⁹ See generally MARC FRANSON & PETER MANBECK, CHAPMAN & CUTLER LLP, *THE REGULATION OF MARKETPLACE LENDING: A SUMMARY OF PRINCIPAL ISSUES* (2019), https://www.chapman.com/media/publication/926_Chapman_Regulation_of_Marketplace_Lending_2019.pdf [<https://perma.cc/KWL6-G6PN>] (describing the results of an annual survey conducted by the law firm Chapman and Cutler LLP on marketplace lending and associated regulatory and securities issues).

⁷⁰ See Verstein, *supra* note 4, at 475-76 (noting that the SEC issued the order to Prosper for failing to register as a public company before selling securities as defined in section 2(a)(1) of the Securities Act).

⁷¹ The two major P2P lenders reacted to regulation by the SEC in different ways. Compare Silla Brush, *Online Lender Lobbies Congress for Industry Consumer Regulator*, THE HILL (June 9, 2010, 11:23 PM), <https://thehill.com/business-a-lobbying/102323-online-lender-lobbies-congress-for-industry-consumer-regulator> [<https://perma.cc/8H32-TY3Z>] (discussing how Prosper aggressively lobbied Congress to place P2P lending regulation under the CFPB and provide an exemption from the

However, the impact on the P2P lending market was dramatic: Prosper and LendingClub were forced to cease offering loans for purchase for approximately eight months and six months, respectively, while they worked through registration with the SEC.⁷² Less-established P2P lenders opted to withdraw from the U.S. market entirely.⁷³ The most immediate effect of SEC regulation was consolidation of the U.S. P2P lending market to two participants and increased entry barriers for any new market entrant.⁷⁴

While the SEC's jurisdiction over P2P lenders like LendingClub and Prosper has not been memorialized, it is generally accepted that the SEC has jurisdiction over the notes sold by these lenders.⁷⁵ Both Prosper and LendingClub originate loans to borrowers and then sell these loans, which both lenders refer to as "notes," to private investors. Given this business model, SEC jurisdiction can be premised either by treating these notes as investment contracts and applying the *Howey* test⁷⁶ or simply by applying the holding in *Reves v. Ernst & Young*.⁷⁷ *Reves* held that using a term like "note" to describe a financial instrument creates a rebuttable presumption that the instrument is a "security" and falls under the purview of the securities laws.⁷⁸ Overall, the industry has recognized its obligations under the securities laws, as no P2P lender has argued that the SEC lacks jurisdiction in this area.

Broadly speaking, regulation by the SEC imposes two primary requirements on P2P lenders that seek to offer notes to nonaccredited investors. First, the lender must itself register with the SEC even if the lender

securities laws for loan products), *with* Slattery, *supra* note 12, at 252 (discussing how LendingClub was proactive in complying with securities regulation and reached out to the SEC in 2008).

⁷² Prosper, in compliance with SEC rules, did not offer lenders the opportunity to purchase notes on its website from October 16, 2008 until it filed a registration statement on July 13, 2009. See Carl Smith, *If It's Not Broken, Don't Fix It: The SEC's Regulation of Peer-to-Peer Lending*, 6 BUS. L. BRIEF (AM. U.) 21, 23 (2010). Similarly, LendingClub "shut down its lending operations from April 7 to October 13, 2008." *Id.* (citations omitted).

⁷³ See Slattery, *supra* note 12, at 257 (noting that Zopa, a U.K.-based P2P lender, left the U.S. market entirely following SEC intervention).

⁷⁴ See *id.* at 258 (estimating that Prosper spent over \$5 million in direct SEC compliance costs and LendingClub incurred roughly \$3 million in SEC compliance costs).

⁷⁵ Even the earliest opponents to SEC jurisdiction over marketplace lenders acknowledged that the SEC had a strong argument for asserting jurisdiction. See, e.g., Verstein, *supra* note 4, at 487-88 (acknowledging that there are "plausible arguments" for SEC jurisdiction but arguing that jurisdiction should not be asserted given strong normative considerations).

⁷⁶ SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (defining an investment contract, for purposes of the Securities Act, as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"); see also Chaffee & Rapp, *supra* note 1, at 513-14 (applying each component of the *Howey* test to notes offered by Prosper and LendingClub and concluding that the notes meet this test).

⁷⁷ 494 U.S. 56 (1990).

⁷⁸ *Id.* at 65; see also Chaffee & Rapp, *supra* note 1, at 514-17 (concluding that the *Reves* holding would cause notes sold by P2P lenders to be considered securities).

does not offer its own equity for sale to the public.⁷⁹ Second, a P2P lender selling to nonaccredited investors must file a supplemental prospectus with the SEC every time it sells a package of notes.⁸⁰ The requirement to file supplemental prospectuses can be quite onerous—in March 2019 alone, LendingClub filed 120 supplemental prospectuses with the SEC.⁸¹ This process is known as “shelf registration,” and it is utilized by both LendingClub and Prosper.

The shelf registration process involves significant upfront costs but allows these lenders to easily and quickly sell their note packages in compliance with the securities laws.⁸² Shelf registration for these two large lenders is executed under Securities Act Rule 415, which allows the lenders to register a generic block of securities (here, the note packages) and subsequently take these securities “off the shelf” when it reaches an agreement to sell the notes to investors.⁸³ Absent this rule, “each [note package]—because its underlying borrower, maturity date, and interest rate won’t in combination match those of any other [note package]—would constitute a distinct series of securities and would have to be separately registered.”⁸⁴ The cost of separate registration would be extremely high, therefore making Rule 415 essential to the operation of large P2P lenders selling to nonaccredited investors.⁸⁵

Some relatively recent statutory and regulatory changes have altered this process, creating a new means for P2P lenders to operate in compliance with the securities laws. The JOBS Act was enacted in April 2012 and created an alternative and less onerous means for P2P lenders to comply with the securities laws.⁸⁶ The provision of the JOBS Act that is of greatest utility to P2P lenders is Rule 506(c), which allows lenders “to engage in general

⁷⁹ See, e.g., LendingClub Corp., Annual Report (Form 10-K) 45 (Apr. 1, 2013) (fulfilling SEC registration and reporting requirements while noting that “[LendingClub has] no publicly traded equity securities”); see also 15 U.S.C. § 78m(a)(2) (2018) (requiring every issuer of registered securities to file an annual report with the SEC).

⁸⁰ See 17 C.F.R. § 229.512(a) (2019) (requiring an issuer utilizing a Rule 415 offering “[t]o file, during any period in which offers or sales are being made, a post-effective amendment to [its] registration statement”).

⁸¹ See Form 424B3 Edgar Search Results for LendingClub Corp., U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/edgar/searchedgar/companysearch.html> [<https://perma.cc/D3EV-39KS>] (last visited Mar. 29, 2020) (search “0001409970” in the Fast Search field; filter by Filing Type “424B3”).

⁸² See FRANSON & MANBECK, *supra* note 69, at 94 (“[Shelf registration] makes registered offerings of Platform Notes possible The filing nonetheless seems to impose an unnecessary expense on [P2P lenders] . . . since P2P investors almost universally will rely upon the platform website and not on SEC filings to access the terms of their Platform Notes.”).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ See *id.* at 147 (explaining that Congress enacted the JOBS Act to exempt small businesses that engage in crowdfunding from securities registration).

solicitations of accredited investors without registering their” note packages with the SEC.⁸⁷ While sales to accredited investors without registration had previously been permitted under certain conditions, the JOBS Act was of great importance because the prior registration exemptions prohibited “general solicitation.”⁸⁸ P2P lenders’ core business is sales of notes over the internet, which could be considered general solicitation.⁸⁹ As discussed later, new P2P lender entrants have begun using Rule 506(c) to avoid the costly and time-consuming shelf registration process.⁹⁰

Under the current securities law regime, incentives for P2P lenders are clear. It is unlikely that there will be any specific legislation exempting P2P lenders from registration under the securities laws, as was once argued for.⁹¹ Rather, it appears that new entrants will rely on the exemptions under Rule 506(c), while established P2P lenders—like LendingClub and Prosper—will increasingly shift their business model to one catered more toward accredited investors.⁹²

B. Regulation by the Federal Banking Agencies

The interplay between P2P lenders and the federal banking agencies is complex and often murky. The extent to which P2P lenders are supervised by the federal banking agencies is also unclear. Because no P2P lenders are currently chartered banks,⁹³ they are generally not subject to direct supervision by federal banking regulators. However, provisions of the Bank Service Company Act and prior guidance statements by the banking agencies indicate that such direct supervision is possible. This is due to the extensive relationships P2P lenders have with banks chartered by state and federal governments.

The academic literature surveyed in this Comment extensively discuss the SEC’s direct regulation of P2P notes but, to this author’s knowledge, none of these articles discuss how banking agencies can regulate P2P lenders indirectly. Indeed, as exemplified by an FDIC Advisory, as well as comments from

⁸⁷ *Id.* at 97.

⁸⁸ See Lo, *supra* note 28, at 93 (discussing the prior private placement exemptions under Rules 506 and 502).

⁸⁹ See *id.* (noting that securities offerings made over the Internet “might be deemed by the SEC to involve general advertising or general solicitation and thus would not qualify for the Rule 506 exemption” and suggesting that to avoid registration, P2P loan platforms would “have to avoid marketing the securities through [these] channels”).

⁹⁰ See *infra* notes 149–151 and accompanying text.

⁹¹ See Brush, *supra* note 71 (discussing how Prosper lobbied Congress for exemption from registration); see also Verstein, *supra* note 4, at 522 (outlining a normative argument for why P2P lenders should be exempt from the scope of the Securities Act).

⁹² See *infra* notes 149–151 and accompanying text for a more thorough discussion of this shift.

⁹³ See Press Release, LendingClub, *supra* note 8 (discussing LendingClub’s planned acquisition of a federally chartered bank for the purpose, in part, of establishing a direct relationship with federal regulators).

LendingClub, it appears that even some within the banking industry may fail to appreciate how P2P lenders are subject to this supervision through their relationships with banks.⁹⁴ Regardless of the exact degree of supervision, P2P lenders are still required to comply with federal laws and regulations over lending practices. Any violation of these laws or regulations could therefore result in an enforcement action brought by federal authorities. The result of this system is that P2P lenders are required to follow federal laws and regulations over lending, though the extent of their compliance with these laws and regulations is less closely monitored than banks.

The potential for federal banking agencies to directly supervise P2P lenders appears to exist—at least to some extent. As noted in Part I, both LendingClub and Prosper utilize chartered banks to fund their loans before selling these loans to private investors.⁹⁵ The primary bank used by both LendingClub and Prosper is WebBank, a state-chartered bank subject to federal supervision by the FDIC.⁹⁶ P2P lenders that utilize chartered banks to originate loans before repurchasing such loans are technically subject to examination and enforcement by that bank's federal regulator. This is because of the contractual relationship governing the underwriting, originating, and servicing of loans between the P2P lender and the chartered bank.⁹⁷ Under the Bank Service Company Act,

[W]henever a depository institution that is regularly examined by [a] . . . Federal banking agency . . . causes to be performed for itself, by contract or otherwise, any services authorized under this Act . . . such performance shall be subject to regulation and examination by such agency to the same extent as

⁹⁴ See Fed. Deposit Ins. Corp., Financial Institution Letter FIL-49-2015, FDIC Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations (Nov. 6, 2015), <https://www.fdic.gov/news/news/financial/2015/fil15049a.pdf> [<https://perma.cc/5TCZ-KCAR>] (“In some situations, it is evident that financial institutions have not thoroughly analyzed the potential risk arising from third-party [nonbank lending] arrangements . . . [T]his Advisory reminds FDIC-supervised institutions that third-party arrangements to facilitate the purchase of loans and participations should be managed by an effective third-party risk management process.”); LendingClub, Comment Letter on “Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective” (May 31, 2016), <https://www.occ.treas.gov/topics/responsible-innovation/comments/occ-lending-club-comment-to-occ-white-paper.pdf> [<https://perma.cc/LUT6-JQ8E>] (“Although often not fully appreciated, [P2P lending] arrangements [with banks] also bring a level of oversight to marketplace lending platforms, which become subject to the bank regulators’ third-party relationship standards.”).

⁹⁵ See LendingClub 10-K, *supra* note 18, at 8-9 (discussing how LendingClub facilitates its loans through WebBank, NBT Bank, and Comenity Capital Bank); Prosper 10-K, *supra* note 18, at 8 (discussing how all Prosper loans are originated through WebBank).

⁹⁶ See *WebBank and Alt Lending’s Perfect Storm*, PYMNTS (Dec. 15, 2015), <https://www.pymnts.com/news/2015/webbank-and-alt-lendings-perfect-storm/> [<https://perma.cc/NP59-EAMT>] (describing WebBank’s status as a Utah industrial chartered bank subject to FDIC oversight and outlining WebBank’s increasing prominence in the alternative lending space).

⁹⁷ See *infra* notes 98–102 and accompanying text.

if such services were being performed by the depository institution itself on its own premises⁹⁸

The effect of this statute is that the federal banking agencies clearly have the authority to supervise and examine P2P lenders. However, the extent to which these agencies have exercised this authority remains an open question.

The banking agencies did previously provide some guidance on how this supervision might come about; however, this guidance was ultimately rescinded, continuing the opaque regulatory status around P2P lenders. Nonetheless, it is worth briefly exploring this guidance to gain some insight into the thinking of federal banking regulators on this topic. In 2016, the FDIC issued proposed guidance addressing lending arrangements between marketplace lenders and chartered banks.⁹⁹ This guidance not only emphasized a variety of requirements with which banks with significant third-party lending arrangements must comply, but it also outlined areas the FDIC might review for third-party lenders such as LendingClub and Prosper.¹⁰⁰ The guidance made clear that both compliance with consumer protection laws and protection of consumer information would be areas of focus.¹⁰¹ However, the guidance was never made final and in 2018, the FDIC proposed retiring it to inactive status.¹⁰²

While this now rescinded guidance may provide insight into how the federal banking agencies might approach these lending arrangements in the future, the current state of regulatory oversight is now governed by the broader regulatory guidance on managing third-party risk. This guidance is focused on the financial institution's practices in assessing and controlling risk associated with third parties, performing due diligence, structuring and reviewing contracts with these third parties, and overseeing their activities.¹⁰³ While this approach certainly does not foreclose the possibility of bank examiners specifically reviewing loans originated on behalf of LendingClub or Prosper, it does not require it. Rather, the focus of the guidance is on the bank's management of these relationships. As noted above, "Under the Bank Service Company Act (BSA), the FDIC and other federal financial

⁹⁸ 12 U.S.C. § 1867(c) (2018).

⁹⁹ Press Release, Fed. Deposit Ins. Corp., Examination Guidance for Third-Party Lending 1 (July 29, 2016), <https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf> [<https://perma.cc/9VTF-ERDJ>].

¹⁰⁰ *Id.* at 12-14.

¹⁰¹ *Id.* at 12-13.

¹⁰² Fed. Deposit Ins. Corp., Financial Institution Letter FIL-46-2018, FDIC Seeks Comment on Proposed Retirement of Certain Financial Institution Letters (Sept. 10, 2018), <https://www.fdic.gov/news/news/financial/2018/fil18046.pdf> [<https://perma.cc/RS8M-VC97>].

¹⁰³ Fed. Deposit Ins. Corp., Financial Institution Letter FIL-44-2008, Guidance for Managing Third-Party Risk (June 6, 2008), <https://www.fdic.gov/news/news/financial/2008/filo8044a.pdf> [<https://perma.cc/F9T3-VVU7>].

regulators have statutory authority to regulate and examine the services performed by third parties”¹⁰⁴ However, it is not clear whether the FDIC or any other federal financial regulator has exercised this authority with respect to any P2P lender.¹⁰⁵

All this leads to the conclusion that the position of the federal banking agencies over P2P lending remains unclear. P2P lenders are subject to the same laws as all lenders, yet they still remain in a gray area of supervision. As Part III explains, however, the banking agencies are taking a more proactive approach to fintech companies broadly through new special purpose bank charters.

C. *The Evolving Approach of State Regulators*

P2P lenders are subject to the regulatory regime of each state in which the lender operates. The most routine interaction between state regulators and P2P lenders is through licensing. The exact type of license required and the costs associated with acquiring licenses can vary significantly across states.¹⁰⁶ Additionally, these licenses are required in some states even where the lender utilizes a chartered funding bank, as is the case with P2P lenders.¹⁰⁷ State regulators appear to have recognized the burden that this complex web of licensing and compliance requirements places on nonbank financial service providers. With a particular focus on fintech companies, the CSBS in 2018 announced an initiative to develop an “integrated, 50-state licensing and supervisory system” for the purpose of “moderniz[ing] state regulation of non-banks, including financial technology firms.”¹⁰⁸ The CSBS recently took a significant step forward in implementing this initiative by rolling out a nationwide examination platform for state regulators to use in supervising fintech companies.¹⁰⁹ While not explicitly depicted as such, this CSBS “Vision

¹⁰⁴ FED. DEPOSIT INS. CORP. OFFICE OF THE INSPECTOR GENERAL, REPORT NO. 06-015, FDIC’S OVERSIGHT OF TECHNOLOGY SERVICE PROVIDERS 2 (2006), <https://www.fdicog.gov/publications/reports06/06-015-508.shtml> [<https://perma.cc/9MD6-NDA2>].

¹⁰⁵ The FDIC did recently rely on its authority under the Bank Service Company Act to pursue an enforcement action against a marketplace lender for engaging in unfair and deceptive practices. See FRANSON & MANBECK, *supra* note 69, at 32. The FDIC required the lender to provide \$20 million in restitution for consumers and imposed a \$500,000 penalty. *Id.*

¹⁰⁶ For a detailed overview of different licensing requirements for nonbank lenders, see *id.* at 60-64.

¹⁰⁷ See *id.* at 62-63 (“Persons who ‘arrange’ loans for others are also covered by the lending license statute in some states. In some cases, a purchaser or assignee of a Borrower Loan may become subject to licensing requirements.”).

¹⁰⁸ See *Vision 2020 for Fintech and Non-Bank Regulation*, CONF. ST. BANK SUPERVISORS (June 7, 2018), <https://www.csbs.org/vision2020> [<https://perma.cc/N6KW-EW9Q>] (discussing Vision 2020 as a series of CSBS initiatives which will “result in a regulatory system that makes supervision more efficient by recognizing standards across state lines”).

¹⁰⁹ Press Release, Conference of State Bank Supervisors, State Financial Regulators Launch Nationwide Technology Platform to Examine Fintechs and Other Nonbanks (Feb. 19, 2020),

2020” seems to be an effort, in part, to rebut attempts by federal banking regulators to extend chartering to nonbank fintech firms.

The CSBS’s proposed integrated licensing and supervisory system fits into a long history of state regulators collaborating to harmonize their differing regulatory regimes. One example of this collaboration particularly relevant to P2P lenders was the development and ongoing expansion of the Nationwide Multistate Licensing System (NMLS), “which is a technology platform that functions as a system of record for the licensing activities . . . of [sixty-two] state or territorial government agencies.”¹¹⁰ The U.S. Department of Treasury has stated that “[t]he NMLS is used by state regulators to reduce duplicative regulatory requirements, promote greater information sharing and coordination, and maintain consumer protections and the strength and resilience of regulated firms.”¹¹¹ Since its creation in 2008, the scope of the NMLS has been expanded to encompass money transmitters, consumer finance providers, and debt collectors.¹¹²

Today, a large number of states utilize the NMLS to manage nonbank licensing and to provide consumers with access to data on nonbank financial service providers.¹¹³ In addition to the expansion of the NMLS, the CSBS and state regulators also adopted an integrated approach to the supervision of money-service businesses. To coordinate supervision of money-service businesses with licenses to operate in multiple states, forty-nine states and territories entered into an agreement to engage in joint, multistate examinations of money-service businesses.¹¹⁴ Overall, these past examples of state coordination provide a roadmap for future efforts by the CSBS and state regulators.

The means by which the CSBS and state regulators have adopted an integrated approach toward licensing and supervision of money-service businesses is relevant to the CSBS’s proposed integrated approach to fintech firms, including P2P lenders. The CSBS has stated that “[b]y 2020, state

<https://www.csbs.org/state-financial-regulators-launch-nationwide-technology-platform-examine-fintechs-and-other> [https://perma.cc/46NM-T9T5].

¹¹⁰ U.S. DEP’T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: NONBANK FINANCIALS, FINTECH, AND INNOVATION 68 (2018), <https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf> [https://perma.cc/UC2N-ZX83] (citation omitted).

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *See id.* (“As of year-end 2017, 38 states were using NMLS to manage their [money-service businesses] licenses Beyond the scope of industries, NMLS has also enabled greater access to its data through the launch of a publicly available consumer access website in 2010”).

¹¹⁴ *See* CONFERENCE OF STATE BANK SUPERVISORS & MONEY TRANSMITTER REGULATORS ASSOC., THE STATE OF STATE MONEY SERVICES BUSINESSES: REGULATION & SUPERVISION 11-13 (2016), <https://www.csbs.org/sites/default/files/2017-11/State%20of%20State%20MSB%20Regulation%20and%20Supervision%202.pdf> [https://perma.cc/RT3L-R7SB].

regulators will adopt an integrated, 50-state licensing and supervisory system, leveraging technology and smart regulatory policy to transform the interaction between industry, regulators and consumers.”¹¹⁵ The CSBS has outlined a six-step plan to accomplish this lofty goal.¹¹⁶ Of particular interest to this Comment are, first, the CSBS’s plans to redesign the NMLS to automate new applicants and enable states to identify higher risks, and, second, the plan to harmonize multistate supervision of fintech firms.¹¹⁷ The redesign of the NMLS is already underway with the intent to develop a new NMLS that will facilitate multistate supervision and increase the amount of disclosure available to consumers.¹¹⁸ Harmonization of state supervision has begun as well, with the nationwide rollout of the State Examination System.¹¹⁹ The purpose of the State Examination System, in part, is to “[s]upport networked supervision among state regulators” and “[m]ove state supervision toward more multistate exams and fewer single-state efforts.”¹²⁰

The modernization efforts by the CSBS could play an important role in reducing the uncertainty financial services companies face in attempting to comply with fifty different state regulatory regimes. Furthermore, better and more efficient supervision and enforcement by state regulators is currently of essential importance to ensuring compliance with federal lending laws since P2P lenders are not directly supervised by federal banking authorities. Because state regulators retain the authority to pursue violations of federal consumer protection laws against nonfederally chartered banks,¹²¹ their role in policing potential violations of federal consumer protection laws is an important complement to the limited enforcement resources of the federal government.¹²² However, there are also significant weaknesses to the CSBS’s plan. The resources available to state regulators are spread even more thinly than those available to their federal counterparts. State regulators are not only

¹¹⁵ *Vision 2020 for Fintech and Non-Bank Regulation*, *supra* note 108.

¹¹⁶ For an outline of the entire plan, see *id.*

¹¹⁷ *Id.*

¹¹⁸ *Work Begins on Next Generation Technology Platform*, CONF. ST. BANK SUPERVISORS (Sept. 7, 2017), <https://www.csbs.org/work-begins-next-generation-technology-platform> [<https://perma.cc/4B52-FPVA>].

¹¹⁹ Conference of State Bank Supervisors, *supra* note 109.

¹²⁰ *Id.*

¹²¹ See 12 U.S.C. § 5552(a)(1) (2018) (establishing a cause of action for state regulators to enforce provisions of the Dodd–Frank Wall Street Reform Act). *But see id.* § 5552(a)(2)(A) (“[T]he attorney general . . . of any State may not bring a civil action in the name of such State against a national bank or Federal savings association to enforce a provision of this title.”).

¹²² See Margaret H. Lemos, *State Enforcement of Federal Law*, 86 N.Y.U. L. REV. 698, 701 (2011) (“Proponents of state enforcement emphasize its potential to buttress federal efforts by putting more ‘cops on the beat.’”).

responsible for supervising all state-chartered banks but also all state-licensed nonbank financial service providers.¹²³

Another weakness to the CSBS plan is that different states place varying degrees of value on financial regulation and enforcement. Because the proposed CSBS system is by its nature voluntary,¹²⁴ the fact that many state regulators may not want to pursue active enforcement of state and federal consumer protection laws could undermine any multistate supervision and enforcement effort. One example of this antiregulatory attitude at the state level can be seen in Arizona's recent push for a "regulatory sandbox" in the state.¹²⁵ In March 2018, the Arizona legislature passed a law that will "allow financial companies to bypass state licensing requirements and offer their products and services to up to 10,000 consumers for a period of two years."¹²⁶

The Arizona Attorney General has argued that "[t]he sandbox will allow entrepreneurs to give new ideas a chance in the real market without incurring the regulatory costs and burdens that would otherwise be imposed."¹²⁷ Consumer protection advocates have been highly critical of this approach, noting that the "Regulatory Sandbox law imposes few disclosure obligations on participants."¹²⁸ These advocates further argued that the waivers provided under the Arizona Regulatory Sandbox could result in disclosures that fail to comply with federal law.¹²⁹ This lack of disclosure would be exacerbated by the fact that participants in the sandbox would be exempt from state licensing, examination, and supervision.

¹²³ *The Role of State Financial Regulation*, CONF. ST. BANK SUPERVISORS (Oct. 24, 2017), <https://www.csbs.org/role-state-financial-regulation> [<https://perma.cc/DA8A-URPA>] ("State regulators are responsible for chartering, licensing and supervising state-chartered banks and non-bank financial services providers . . .").

¹²⁴ The CSBS is a nonprofit organization that serves as the "national forum [for state regulators] to coordinate bank and nondepository supervision and to develop regulatory policy." Complaint at 7, *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, 2019 U.S. Dist. LEXIS 149531 (D.D.C. Sept. 3, 2019) (No. 18-02449) [hereinafter CSBS Complaint]. The CSBS cannot bind member states to its proposals but must instead rely on negotiated cooperative agreements. *See, e.g.*, Nationwide Cooperative Agreement for State Governance of Non-Depository Supervision art. 2, § 2.4, Oct. 7, 2013, <https://www.csbs.org/sites/default/files/2017-11/State%20Governance%20Agreement%20Master%20Signature.pdf> [<https://perma.cc/5EW5-GJ MX>] ("Each State Regulator voluntarily participating in coordinated supervisory processes under this Agreement and the Framework retains all sovereign rights and independent authorities granted by state law. *Nothing in this Agreement shall be legally binding on any State Regulator.*" (emphasis added)).

¹²⁵ FRANSON & MANBECK, *supra* note 69, at 11.

¹²⁶ *Id.* at 89.

¹²⁷ Press Release, Ariz. Attorney Gen. Mark Brnovich, Arizona Becomes First State in U.S. to Offer Fintech Regulatory Sandbox (Mar. 22, 2018), <https://azag.gov/press-release/arizona-becomes-first-state-us-offer-fintech-regulatory-sandbox> [<https://perma.cc/V7ME-YFTG>].

¹²⁸ Kelly Griffith, SW Center for Economic Integrity, Comment Letter on CFPB Proposed Rule: Policy to Encourage Trial Disclosure Programs 1 (Oct. 9, 2018), <https://www.regulations.gov/document?D=CFPB-2018-0023-0028> [<https://perma.cc/S8YK-GAJP>].

¹²⁹ *Id.* at 3.

The experience of the Arizona Regulatory Sandbox highlights the limits of the CSBS state-based approach: if we are to rely on the CSBS plan to ensure nationwide consumer protection, then every state must express the same commitment. The fact that states vary significantly in their views on the appropriate level of supervision and enforcement over consumer protection means that a state-focused approach to nonbank financial firms will likely never result in consistent application of consumer protection laws.

III. A NEW REGULATORY APPROACH

The current regulatory approach toward P2P lenders is broken. When P2P lending was still in a nascent state, it was appropriate to heed the advice of those urging a wait-and-see approach regarding regulation.¹³⁰ However, P2P lending has existed for well over a decade and we are now positioned to assess the best regulatory regime. As has been discussed previously, P2P lending has arguably produced benefits for consumers but also raises unique consumer harm concerns.¹³¹ Aside from the unique risks presented by P2P lending, this form of lending increasingly looks simply like a less regulated form of traditional lending. The vast majority of the loans generated on these platforms are funded by either banks or sophisticated accredited investors. However, these lenders are less regulated than traditional bank lenders. The current regulatory regime is not advantageous for P2P lenders either. Instead of facing oversight by a single federal agency, P2P lenders must face a complex array of state-by-state regulation while still ensuring compliance with federal lending laws. Overall, this structure does not appear to benefit consumers or lenders.

To fix this currently flawed regulatory structure, lenders and regulators should push for chartering of P2P firms. Several fintech firms have already pursued state bank charters, indicating that bank charters in the twenty-first century can benefit nontraditional financial firms.¹³² Furthermore, LendingClub is moving forward with a plan to acquire a federally chartered bank, a clear signal that a national charter will benefit the P2P business model.¹³³ While some continue to argue that single-point regulation by the CFPB is the best regulatory approach, the past actions of the CFPB and the

¹³⁰ See Chaffee & Rapp, *supra* note 1, at 531 (asserting in 2012 that “[i]n the short-term, Congress should adopt a wait-and-see approach to regulating P2P lending” and that “[t]he lending model used by both Prosper and LendingClub is adequately regulated by existing law”).

¹³¹ See *supra* notes 44–68 and accompanying text (describing the risks and benefits that alternative data offers to consumers).

¹³² Clozel, *infra* note 197 and accompanying text (discussing efforts by Square and SoFi to obtain state industrial loan charters).

¹³³ Press Release, LendingClub, *supra* note 8.

current deregulatory emphasis at the agency make such a change unlikely.¹³⁴ Additionally, as of February 2020, the CFPB faces an “existential threat at the U.S. Supreme Court” over its potentially unconstitutional structure.¹³⁵ In contrast, the OCC has already established a special purpose national bank charter for fintech firms.

A special purpose bank charter provides several advantages over the status quo. First, it will ensure that P2P lenders are subject to direct and unambiguous supervision by a federal banking regulator. This will produce more consistent compliance within the industry. Second, a national charter will provide P2P lenders with preemption of state law. There are certainly concerns inherent with preemption. However, the benefits of preemption for P2P lenders should outweigh the costs. This is because state-law preemption will incentivize P2P lenders to opt for national chartering, ensuring that consistent federal supervision is present for these entities as opposed to inconsistent state supervision and enforcement. Third, a special purpose bank charter specifically targeted toward fintech firms will allow for more tailored regulation of these entities. The specificity of this charter will allow regulators to gain a deeper understanding of the benefits and risks of these firms and ideally create a strong regulatory foundation for these firms to grow in the future. Finally, fintech chartering should produce broader economic benefits by reducing systemic risks associated with these firms and potentially preventing a future crisis.

Section A of this Part discusses why the current state of regulation over P2P lenders is inadequate, both under the securities laws and the Bank Service Company Act. It also argues that regulation by the CFPB, while an appealing alternative, is unlikely to occur at any time in the foreseeable future. Section B then argues for federal chartering of P2P lenders, providing a discussion on the development of the OCC fintech charter and the challenges that a special purpose charter would face.

A. *The Status Quo of Federal Regulation Is Inadequate*

The current state of the federal regulatory regime over P2P lenders consists solely of the application of the securities laws by the SEC¹³⁶ and opaque supervision and enforcement by federal banking regulators of P2P

¹³⁴ For a more contemporary argument that the CFPB should be the single-point regulator for P2P lenders, see Warren, *supra* note 9, at 304-305 (noting that the CFPB has a broad mandate and that single-point regulation is overall more efficient). As I argue in this Comment, while the CFPB may be best suited to regulate P2P lenders, it is unlikely that it will actually attempt to do so anytime in the near future.

¹³⁵ Alison Frankel, *Trump's DOJ Urges Supreme Court to Keep CFPB Up and Running*, REUTERS (Feb. 18, 2020, 5:00 PM), <https://www.reuters.com/article/us-otc-cfpb-idUSKBN20C2M3> [<https://perma.cc/CSK7-E9GB>].

¹³⁶ See *supra* Section II.A.

lenders as third-party service providers.¹³⁷ This Section rejects the status quo of federal regulation over P2P lenders as inadequate. First, this Section evaluates arguments by Benjamin Lo that the securities laws alone are sufficient for P2P lenders. In evaluating this argument, this Section rejects the underlying premise that investors, rather than borrowers, are in greatest need of protection.

Second, this Section evaluates the adequacy of regulating P2P lenders as third-party service providers under the Bank Service Company Act. This Section rejects this approach as both underprotective for consumers and undesirable for P2P lenders. This Section also rejects a regulatory approach focused on the CFPB based on the pragmatic ground that the CFPB has shown no intent of intervening in this market.

Finally, this Section takes a deeper look at the new approach of regulatory sandboxes toward P2P lenders. This Section acknowledges that regulatory sandboxes may play an important role in fostering nascent financial technologies. However, it rejects the idea that P2P lenders are appropriate participants in a regulatory sandbox since the P2P lending business model is no longer truly “innovative” and, even if it were, the massive scale and reach of these lenders justifies a more stringent regulatory approach.

1. Is Securities Regulation All We Need?

The application of the securities laws to P2P lenders is unlikely to change. Much of the early writing on the regulatory regime around P2P lending argued that these lenders should be exempt from the securities laws, with the CFPB acting as the sole authority over P2P lending.¹³⁸ However, the fact that the SEC asserted itself over P2P lenders more than ten years ago and, since then, Congress has rejected efforts to exempt P2P lenders from the securities laws indicates that such an exemption is unlikely to ever come. Furthermore, the need for such an exemption has been undermined by the JOBS Act, a fact that this Comment previously addressed¹³⁹ and will discuss in greater detail below.

In contrast to arguments that sole authority over P2P lenders should be placed in the CFPB, Benjamin Lo, in a Comment in the *Harvard Business Law Review Online*, has argued that the status quo of P2P lending regulation is in no need of change.¹⁴⁰ Lo makes two distinct arguments to support this

¹³⁷ See *supra* Section II.B.

¹³⁸ See Slattery, *supra* note 12, at 236 (“Most P2P lending activity should be exempt from the SEC’s jurisdiction as it was under the House version of Dodd–Frank.”); Verstein, *supra* note 4, at 529 (arguing that P2P lenders should be “freed from confines of the Securities Acts” and that “regulators have hamstrung [P2P lending] with misguided applications of the Securities Acts”).

¹³⁹ See *supra* notes 86–92 and accompanying text.

¹⁴⁰ See generally Lo, *supra* note 28.

proposition: first, that the expansion of the private placement rules has reduced the burden of the securities laws and reduced barriers to entry for P2P lending,¹⁴¹ and second, that investors in P2P notes, rather than borrowers, require greater protection, thereby making the securities laws the most appropriate regulatory approach.¹⁴² In this Section, I evaluate both arguments. I conclude that while Lo is correct in his first argument regarding the reduced burden under the securities laws, the premise of his second argument that investors require greater protection than borrowers is flawed given the increased prevalence of sophisticated investors in P2P lending.

Many of the early concerns about the application of the securities laws to P2P lenders were based on the compliance burden associated with these laws.¹⁴³ Paul Slattery, in a Note for the *Yale Journal on Regulation*, argued that these compliance requirements could create potentially insurmountable barriers to entry for new P2P lenders, the effect of which would be the entrenchment of the two legacy lenders, LendingClub and Prosper.¹⁴⁴ In contrast, Lo has argued that the expansion of private placement exemptions under the JOBS Act should eliminate concerns about barriers to entry for new P2P lenders.¹⁴⁵ Lo focuses particularly on Rule 506(c), which “permits issuers to use general solicitation and general advertising . . . when conducting an offering pursuant to [Rule 506(c)], provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors.”¹⁴⁶ Lo argues that this exemption could be used by new entrants.¹⁴⁷ He anticipates that “new entrants can start with Rule 506(c) to grow their customer base” and “[o]nce they obtain funding . . . transition to shelf-registration to ensure that their securities enjoy the full benefits of a registered offering.”¹⁴⁸

This argument is at least somewhat supported by the practices of emerging P2P lenders in this area. Two firms whose experience supports this proposition are Funding Circle and Upstart. Funding Circle is a P2P lender that started in the United Kingdom and entered the U.S. market in 2013, shortly after the

¹⁴¹ See *id.* at 92-95 (arguing that the SEC’s Rule 506(c) and crowdfunding exemption contribute to the effectiveness of existing SEC regulation of lenders).

¹⁴² *Id.* at 95-97 (asserting that lenders need more protection than borrowers and that the SEC should intervene on their behalf).

¹⁴³ See, e.g., Slattery, *supra* note 12, at 273 (arguing that the burdens of compliance with the securities laws “weigh heaviest on innovative financial firms in novel spaces”); Verstein, *supra* note 4, at 510 (“P2P platforms face substantial compliance burdens similar to traditional public company issuers, despite posing different risks . . .”).

¹⁴⁴ Slattery, *supra* note 12, at 254-57.

¹⁴⁵ Lo, *supra* note 28, at 92-95.

¹⁴⁶ *Id.* at 93 (citation omitted).

¹⁴⁷ *Id.* at 94.

¹⁴⁸ *Id.*

passage of the JOBS Act. Unlike Prosper and LendingClub, Funding Circle's primary focus is small business loans and has lent over two billion dollars to small businesses in the United States.¹⁴⁹ Funding Circle has stated that it now has one of the fifty largest small-business loan portfolios in the United States.¹⁵⁰ And of key importance to this discussion, all notes issued by Funding Circle to investors are made under the 506(c) exemption.¹⁵¹

The main problem with Lo's argument is his claim that investors need greater protection than borrowers in the P2P lending space.¹⁵² To support this argument, he engages in an empirical analysis that he argues shows that borrowers on P2P platforms generally obtain lower rates and "appear relatively free from predatory penalties and collection practices."¹⁵³ In contrast, Lo argues that investors in P2P notes tend to improperly analyze the "dizzying array of information upon which to base a lending decision," incorrectly assess the risk of notes, and make suboptimal investment decisions.¹⁵⁴ This appears to occur despite the fact that a P2P lender, like Lending Club, generally incorporates disclosed information into loan quality grades.¹⁵⁵ Given this, Lo argues that investors are in need of greater protection than borrowers and argues that the SEC remains the appropriate agency to ensure that these protections exist.¹⁵⁶

There is a key problem with this analysis and, as a result, the conclusions reached. The fatal issue is that the data set used in this empirical analysis was based on loans made between 2007 and 2013.¹⁵⁷ Since that time, the composition of investors in P2P lending platform notes has changed significantly. Lo's analysis is based on data from LendingClub and his conclusions are based on the assumption that individual retail investors

¹⁴⁹ *Funding Circle US Small Business Loan Portfolio Surpasses Most Banks with \$2 Billion Lent Through Platform*, FUNDING CIRCLE (March 1, 2019), <https://www.fundingcircle.com/us/resources/funding-circle-us-small-business-loan-portfolio-surpasses-most-banks-with-2-billion-lent-through-platform/> [https://perma.cc/BQM4-DH44].

¹⁵⁰ *Id.*

¹⁵¹ See FUNDING CIRCLE SEC., GETTING STARTED AS AN INVESTOR: WELCOME PACKET FOR INVESTORS 7, https://static.fundingcircle.com/files/us/InvestorGuide_082516-4bc90e87.pdf [https://perma.cc/SB8D-6TDW] (last visited Feb. 27, 2020) ("Notes are being offered and sold under the exemption provided by section 4(a)(2) of the Securities Act and Regulation D promulgated thereunder . . ."); see also *Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answers-rule506htm.html> [https://perma.cc/2LQA-TL5L] (last visited Mar. 29, 2020) (describing Rule 506 of Regulation D as providing "a 'safe harbor' under Section 4(a)(2) of the Securities Act").

¹⁵² Lo, *supra* note 28, at 96-97.

¹⁵³ *Id.* at 101.

¹⁵⁴ *Id.* at 102-03.

¹⁵⁵ *Id.* at 103.

¹⁵⁶ *Id.* at 110.

¹⁵⁷ *Id.* at 97.

comprise the greatest portion of LendingClub note investors.¹⁵⁸ However, today small retail investors make up less than 10% of the investor base at LendingClub and banks are the largest purchasers.¹⁵⁹ This is also the case for Prosper with 94% of its loans being funded through its “whole loan channel,” which is only available to accredited investors, many of whom are institutional investors.¹⁶⁰ The fact that the vast majority of P2P note investors are large and sophisticated undermines the proposition that the greatest risks in these products fall on investors. Further undermining this argument is LendingClub’s and Prosper’s increasing reliance on securitizations and whole loan sales that are exempt from the securities laws.¹⁶¹

Therefore, in stark contrast to Lo’s original premise, the current investor base of P2P lending platforms indicates that consumer protection is of much greater concern than investor protection. Large, sophisticated investors possess the means to fend for themselves when it comes to purchasing P2P notes. Individual borrowers taking out small dollar, high interest loans, however, remain vulnerable.¹⁶² This fact points to the conclusion that greater consumer protection is needed.

2. Federal Regulators’ Consumer-Protection Approach Is Inadequate

There are two primary federal regulatory alternatives to an OCC fintech charter: maintaining the status quo where P2P lenders are regulated as third-party service providers or increasing the CFPB’s presence in the P2P lending area. Both alternatives are inadequate.

As previously discussed, the status quo of regulating P2P lenders as third-party service providers is bad for both consumers and lenders.¹⁶³ From a consumer protection standpoint, it is unclear the extent to which P2P lenders are subject to supervision. This opacity fails to provide assurance that federal authorities are actually enforcing compliance with consumer protection laws for P2P lenders. This system is also less than ideal for P2P lenders: like a chartered bank, they remain subject to potential supervision and enforcement by federal banking agencies but get none of the benefits of a chartered bank, including the public confidence associated with such charters and the benefits of state law preemption. Furthermore, the FDIC’s confusing decision to issue draft guidance on third-party lending, never finalize this guidance, and later

¹⁵⁸ See *id.* at 102 n.73 (noting that a LendingClub memo indicated that individual retail investors were the predominant investors funding loans in 2010 and 2011).

¹⁵⁹ See LendingClub 10-K, *supra* note 18, at 131 (reporting that in the final quarter of 2018, self-directed accounts made up 6% of loan origination volume issued, while bank accounts were 41%).

¹⁶⁰ Prosper 10-K, *supra* note 18, at 8.

¹⁶¹ See *supra* notes 34–35 and accompanying text.

¹⁶² See *supra* notes 56–68 and accompanying text for a discussion of the risks posed by P2P lenders.

¹⁶³ See *supra* Section II.B.

retract this guidance indicates that even the regulators are uncertain about their exact authority in regulating P2P lenders as third-party service providers.¹⁶⁴ The sum result is that all parties under the status quo appear uncertain as to the actual effect of regulating P2P lenders as third-party providers.

Waiting for the CFPB to assert itself into P2P lending also appears to be a suboptimal approach, albeit for a different reason—the CFPB, under both Democratic and Republican administrations, has not shown any desire to actively regulate this market. Under the Obama administration, it appears that the CFPB considered taking a more active role in regulating P2P lenders and took two steps in that direction. First, the CFPB began accepting complaints on consumer loans obtained from online marketplace lenders, including P2P lenders.¹⁶⁵ Second, the CFPB issued a request for information on the effect of alternative data on consumers.¹⁶⁶ Some in the financial press concluded that CFPB regulation was imminent.¹⁶⁷ However, the CFPB never pursued any rulemaking or enforcement in this area.

Under the Trump administration, the CFPB has actively sought to scale back the degree of regulation over P2P lenders and other fintech firms. The CFPB has signaled this new deregulatory attitude toward P2P lenders in two ways. First, the CFPB, taking a note from the State of Arizona,¹⁶⁸ issued a proposed rule that would allow fintech firms to participate in a “trial disclosure program” that would exempt the firm from Federal disclosure requirements.¹⁶⁹ The CFPB has argued that this disclosure program will

¹⁶⁴ See *supra* notes 93–102 and accompanying text for a more thorough discussion of the FDIC’s foray into this area.

¹⁶⁵ Press Release, Consumer Fin. Prot. Bureau, CFPB Now Accepting Complaints on Consumer Loans from Online Marketplace Lender (Mar. 7, 2016), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender/> [https://perma.cc/PVQ4-KDVC].

¹⁶⁶ CONSUMER FIN. PROT. BUREAU, *supra* note 46, at 1.

¹⁶⁷ See *CFPB Puts P2P Lenders Under the Microscope*, FINEXTRA (Mar. 8, 2016), <https://www.finextra.com/newsarticle/28578/cfpb-puts-p2p-lenders-under-the-microscope> [https://perma.cc/9WHE-C4TF] (noting that the CFPB is “ramping up the regulatory pressure on the nascent P2P industry” by having consumers submitting complaints “among the different categories for products and services that best apply to their situation, whether that be for a ‘mortgage’, ‘consumer loan’, or ‘student loan’”).

¹⁶⁸ Notably, Paul Watkins, “a [former] lawyer in the Arizona attorney general’s office who helped write [the Arizona Fintech Sandbox law], [now] lead[s] the bureau’s Office of Innovation.” Kate Berry, *CFPB Taps Arizona Official to Lead Innovation Office*, AM. BANKER (July 18, 2018), <https://www.americanbanker.com/news/cfpb-names-arizona-attorney-to-head-office-of-innovation> [https://perma.cc/HRG4-UDRD].

¹⁶⁹ Policy to Encourage Trial Disclosure Programs, 83 Fed. Reg. 45,574, 45,576 (Sept. 10, 2018). This trial disclosure program was subsequently revised to include *all* financial services companies that are considered covered entities for the purpose of CFPB regulations. See Press Release, Consumer Fin. Prot. Bureau, CFPB Office of Innovation Proposes ‘Disclosure Sandbox’ for Companies to Test New Ways to Inform Consumers (Feb. 7, 2019), <https://www.consumerfinance.gov/about-us/blog/cfpb-office-innovation-proposes-disclosure-sandbox-companies-test-new-ways-inform-consumers/> [https://perma.cc/49N5-QYAM].

“enhance consumer protection by facilitating innovation in financial products and services through enabling responsible companies to research informative, cost-effective disclosures in test programs.”¹⁷⁰ Consumer groups, on the other hand, have vehemently opposed the disclosure program, arguing that it “allows legal waivers based only on industry cost savings, with no improvement in consumer understanding and even with potential consumer harm.”¹⁷¹ The second deregulatory signal that the CFPB made was a no-action letter sent to Upstart, a P2P lender. The no-action letter was the first in CFPB history signifying that the CFPB “has no present intent to recommend initiation of supervisory or enforcement action against Upstart with respect to the Equal Credit Opportunity Act” over Upstart’s use of alternative data.¹⁷² Overall, these two recent steps by the CFPB indicate that it has no intention of taking a stronger position in supervising and enforcing potential consumer protection violations within the fintech industry, including P2P lending.

3. A Deeper Look at Regulatory Sandboxes

Before addressing normative recommendations for a federal charter approach, it is worthwhile to briefly discuss the increased attention on the use of regulatory sandboxes for fintech firms. Sandboxes are a recent introduction to the regulatory toolbox intended to provide “a ‘safe space’ in which businesses can test innovative products or services without immediately incurring all the normal regulatory consequences of engaging in the activity in question.”¹⁷³ The sandbox approach is popular in foreign financial centers, with one Article finding that, as of August 2017, at least sixteen foreign jurisdictions had either operational or announced sandboxes.¹⁷⁴ The list of jurisdictions that have adopted the sandbox approach includes major global financial centers such as the United Kingdom, Singapore, Hong Kong, and Switzerland.¹⁷⁵ Additionally, three states within the United States have adopted regulatory sandboxes:

¹⁷⁰ Policy to Encourage Trial Disclosure Programs, *supra* note 169, at 45,576.

¹⁷¹ Allied Progress et al., Comment Letter on Opposition to Policy to Encourage Trial Disclosure Program (Oct. 10, 2018), <https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2018/10/group-comments-to-CFPB-trial-disclosure-programs-oct2018.pdf> [<https://perma.cc/9P7X-3LE3>].

¹⁷² Press Release, Consumer Fin. Prot. Bureau, CFPB Announces First No-Action Letter to Upstart Network (Sept. 14, 2017), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/> [<https://perma.cc/A69B-VEH6>].

¹⁷³ Lee Reiners, *North Carolina’s Proposed Regulatory Sandbox Needs Work*, THE FINREG BLOG (May 28, 2019), <https://sites.duke.edu/thefinregblog/2019/05/28/north-carolinas-proposed-regulatory-sandbox-needs-work/> [<https://perma.cc/QT5Q-B2C9>] (citation omitted).

¹⁷⁴ Dirk A. Zetzsche et al., *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 FORDHAM J. CORP. & FIN. L. 31, 64-66 (2017).

¹⁷⁵ *Id.*

Arizona,¹⁷⁶ Wyoming,¹⁷⁷ and Utah.¹⁷⁸ And as previously stated, the CFPB has introduced a narrow “sandbox” focused on federally mandated disclosures.¹⁷⁹

Notably, while all of these jurisdictions use the term “sandbox,” the features and operations of these various sandboxes differ dramatically on questions of what companies qualify for entry, the scope of the sandbox’s coverage, the level of regulatory compliance for sandbox participants, and the grounds upon which a sandbox participant loses sandbox privileges.¹⁸⁰ Hilary Allen, while skeptical of the normative arguments for sandboxes, has argued that, to be effective, a model regulatory sandbox in the United States “must preempt enforcement actions by individual federal financial regulatory agencies as well as by the States.”¹⁸¹ This preemption benefit would be coupled with close ongoing monitoring by an agency and collaborative information sharing between the firm and the agency.¹⁸²

One of the preliminary problems with discussing fintech sandboxes, as noted by Hilary Allen, is definitional: What types of firms should qualify as “fintechs?”¹⁸³ This Comment does not engage with the broader and still ongoing debate of defining the type of “financial innovation” that should warrant new regulatory approaches like sandboxes.¹⁸⁴ However, factors identified by Zetzsche et al. and by Allen,¹⁸⁵ as well as criteria used by regulatory sandboxes operating in foreign jurisdictions, indicate that a sandbox would be an inappropriate approach to regulating most P2P lending firms. The academic literature and regulatory authorities largely agree that fintech firms that are already regulated entities should not qualify to participate in a regulatory sandbox. For example, Australia, the United Kingdom, Singapore,

¹⁷⁶ See *supra* text accompanying notes 125–128.

¹⁷⁷ Reiners, *supra* note 173.

¹⁷⁸ *Id.*

¹⁷⁹ See *supra* notes 168–171 and accompanying text (discussing the CFPB disclosure sandbox).

¹⁸⁰ For a comprehensive discussion of these differences, see Zetzsche, *supra* note 174, at 69–77.

¹⁸¹ Allen, *supra* note 40, at 643.

¹⁸² *Id.* at 635–36.

¹⁸³ See *id.* at 585 (noting that there exists no definitive category of products and services qualifying as fintech).

¹⁸⁴ See *id.* at 606–08 (noting that “[i]t is currently a subject of hot debate whether fintech is sufficiently different from preceding waves of financial innovation to warrant specialized regulatory attention” and surveying competing views on this point).

¹⁸⁵ Based on a survey of sandboxes across numerous jurisdictions, Zetzsche et al. have stated that before allowing a proposed entrant into a regulatory sandbox, regulators must assess whether the entrant: (1) offers a financial technology, service, or activity that is innovative and beneficial to consumers; (2) “has a need for the sandbox, or whether the [product] is already appropriately covered under existing law and regulation”; and (3) is adequately prepared to participate in a sandbox. Zetzsche et al., *supra* note 174, at 69–71. Allen has approved of the selection criteria used by regulators in the United Kingdom, which require genuine innovation; benefit to consumers; an idea that is “meant for the [domestic] financial services market”; “a need for testing in the sandbox alongside the [regulator]”; and “readiness to test.” Allen, *supra* note 40, at 626.

and the Netherlands, among others, generally only permit currently unregulated entities to participate in sandboxes while requiring regulated firms to rely on no-action letters, informal guidance, and waivers.¹⁸⁶ As Hilary Allen has argued, restricting sandbox access to only unregulated entities is supported by the need to reduce barriers to entry for small, innovative startups: “[F]inancial regulation is likely to pose a bigger hurdle for hitherto unregulated startups than it will for firms that are already subject to financial regulation.”¹⁸⁷ A second kind of requirement for sandbox participation is that the firm must offer an innovation that will produce an “identifiable benefit to consumers.”¹⁸⁸ These benefits may “take the form of reduced costs, increased efficiency, and wider access to financial products and services.”¹⁸⁹

P2P lenders do not appear to sufficiently satisfy either of these factors to qualify for entry into a regulatory sandbox. As established earlier in this article, P2P lenders are already regulated by numerous federal and state agencies and have been subject to regulation for many years.¹⁹⁰ Furthermore, as I have argued, the business model of P2P lending is no longer innovative. Rather, it is better characterized as “the new application of technologies to traditional products or services,”¹⁹¹ namely consumer lending. To the extent that P2P lending is an innovative product, it is in the way these firms offer investment opportunities in consumer loans to retail investors and use alternative data in underwriting loans. Concerning the regulation of the investment products offered by P2P lenders, the barriers to entry are already significantly reduced through the private placement rules under the JOBS Act.¹⁹² Additionally, as the investor base in P2P loans skews increasingly toward large, sophisticated investors, it becomes less apparent that this business model provides benefits to retail consumers.¹⁹³ The use of alternative data by these firms is arguably more innovative. However, given the large size of most P2P lending firms and the fact that alternative data still hews closely to many traditional lending metrics, this would be an attenuated justification for providing P2P lenders with regulatory relief in the form of a sandbox.

Even if one believes that sandboxes are a good policy choice, that view does not obviate the need for fintech chartering. In fact, it may be quite the opposite, as regulatory sandboxes tend to go hand-in-hand with fintech

¹⁸⁶ Zetzsche et al., *supra* note 174, at 73 & n.164.

¹⁸⁷ Allen, *supra* note 40, at 589.

¹⁸⁸ *Id.* at 627 (citation omitted).

¹⁸⁹ *Id.*

¹⁹⁰ See *supra* Part II (discussing discrete examples of regulation faced by P2P lenders).

¹⁹¹ Allen, *supra* note 40, at 606 (citation omitted).

¹⁹² See *supra* notes 86–90 and accompanying text (discussing how the JOBS Act permits certain lenders to solicit investors without registering their securities with the SEC).

¹⁹³ See *supra* notes 28–41 and accompanying text (discussing the rise of sophisticated investors in the market for financial instruments created by P2P lenders).

chartering. Zetzsche et al. have argued that “Smart Regulation” should involve four stages: (1) a testing and piloting environment; (2) a regulatory sandbox; (3) a special charter scheme; and (4) eventually operating under a full license.¹⁹⁴ If the federal government opts to pursue regulatory sandboxes in the same vein as the United Kingdom, then it seems appropriate for the firms that participate in the sandboxes, after benefiting from the sandbox’s low-regulatory environment, to enter into a more traditional regulatory relationship as a chartered financial institution. This approach will not only help attract and foster innovative firms, but also ensure that consumer protection remains paramount throughout the firm’s lifecycle.

B. *The OCC Fintech Charter—The Best Path Forward*

Given the issues with the current regulatory approach toward P2P lenders, it is time to pursue a new paradigm for regulation.¹⁹⁵ This Section posits that fintech chartering ought to be central to that new paradigm. Regardless of whether the OCC fintech charter withstands legal challenges, it appears that chartering for large fintech companies is inevitable. In the absence of a national fintech charter option, large fintech firms have turned to alternative charter options. For example, LendingClub is moving forward with a plan to acquire a federally chartered bank.¹⁹⁶ Additionally, both Square, a payment processor and one of the largest fintech firms, and SoFi, a loan-refinancing fintech firm focused primarily on student loans, have pursued Utah-based industrial loan company (ILC) charters.¹⁹⁷ The move has been met with some controversy¹⁹⁸ but reflects a trend with larger fintech firms seeing the benefits of chartering.

A special purpose bank charter through the OCC, however, is a better approach as compared to full-fledged bank chartering. This Section begins by providing an overview of the OCC fintech charter along with the legal and policy challenges that have been lodged against it by the New York State Department of Financial Services (NYDFS) and the CSBS. This Section

¹⁹⁴ Zetzsche et al., *supra* note 174, at 98.

¹⁹⁵ The terminology of a “new paradigm” for fintech regulation comes from a piece that broadly discusses the evolving paradigm for financial regulation. See Douglas W. Arner et al., *The Evolution of Fintech: A New Post-Crisis Paradigm?* 3-4 (Univ. of Hong Kong Faculty of Law, Research Paper No. 2015/047, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2676553 [<https://perma.cc/9S9P-78QQ>].

¹⁹⁶ Press Release, LendingClub, *supra* note 8.

¹⁹⁷ Lalita Clozel, *Square’s Bid to be Industrial Bank Inflames ILC Debate*, AM. BANKER (Sept. 16, 2017), <https://www.americanbanker.com/news/square-to-apply-for-industrial-bank-inflaming-ilc-debate> [<https://perma.cc/AKY4-ZFQC>].

¹⁹⁸ See *id.* (discussing opposition to ILC charters by the Independent Community Bankers of America).

then outlines the benefits that an OCC fintech charter will provide to consumers, the P2P lending industry, and the broader U.S. economy.

1. Background of the OCC Fintech Charter

On December 2, 2016, the OCC announced through a request for information that it was considering establishing a special purpose national bank charter for fintech companies.¹⁹⁹ On July 31, 2018, the OCC officially announced that it would “begin accepting applications for national bank charters from nondepository financial technology companies . . . engaged in the business of banking.”²⁰⁰ The OCC argued that fintech chartering would ensure that these companies operate in a safe and sound manner, would promote regulatory consistency across the financial industry, would strengthen the federal banking system, and would encourage fair access and inclusion to financial services.²⁰¹ Notably, the OCC fintech charter appears to be the first type of national bank charter provided to institutions that do not receive deposits; all that is required is that the entity engage in “any . . . activities within the business of banking.”²⁰²

Obtaining a fintech charter through the OCC largely mirrors the charter application process for national bank charter applicants.²⁰³ The charter application process is split into four phases: (1) a “prefiling phase” that involves “formal and informal meetings” with the OCC to discuss the application; (2) a “filing phase, in which the [firms] submit a complete application”; (3) a “review phase,” where the OCC assesses the adequacy of the application; and (4) the “decision phase.”²⁰⁴ Applicants are assessed under a variety of considerations, including the applicant’s ability to “provide fair access to financial services, . . . promote fair treatment of

¹⁹⁹ News Release, Office of the Comptroller of the Currency, OCC to Consider Fintech Charter Applications, Seeks Comment (Dec. 2, 2016), <https://occ.gov/news-issuances/news-releases/2016/nr-occ-2016-152.html> [<https://perma.cc/5KSY-QR2P>].

²⁰⁰ News Release, Office of the Comptroller of the Currency, OCC Begins Accepting National Bank Charter Applications from Financial Technology Companies (July 31, 2018), <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html> [<https://perma.cc/H6L6-MPFK>].

²⁰¹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES 2 (2016), <https://www.occ.gov/topics/responsible-innovation/comments/pub-special-purpose-nat-bank-charters-fintech.pdf> [<https://perma.cc/CGY5-DD9D>].

²⁰² *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, 313 F. Supp. 3d 285, 292 (D.D.C. 2018) (citing 12 C.F.R. § 5.20(e)(1) (2019)).

²⁰³ See OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER’S LICENSING MANUAL SUPPLEMENT: CONSIDERING CHARTER APPLICATIONS FROM FINANCIAL TECHNOLOGY COMPANIES 3 (2018) [hereinafter COMPTROLLER’S LICENSING MANUAL SUPPLEMENT] (“The OCC uses its established chartering standards and procedures as the basis for processing applications for all national banks, including [special purpose national banks].”).

²⁰⁴ *Id.* at 3-4.

customers, and . . . ensure compliance with laws and regulations.”²⁰⁵ As part of the application process, applicants must demonstrate a “commitment to financial inclusion” and outline detailed “metrics for serving the [firm’s] anticipated market and community.”²⁰⁶ These elements of the chartering process make clear that consumer protection and financial inclusion are among the OCC’s primary considerations.

The fact that many fintech firms have already been operating for several years with established operational track records should smooth the fintech charter application process. While the OCC has yet to issue a fintech charter, several fintech companies have reportedly expressed interest in such a charter. As of the writing of this Comment, “Online lender Avant is said to be in ‘late-stage discussions’ concerning the approval of an [OCC] Fintech charter.”²⁰⁷ Additionally, Robinhood, an online investment platform, was also reportedly seeking a fintech charter.²⁰⁸ And while the outcome of these reported discussions is yet to be determined, the interest in the OCC fintech charter indicates that it will be increasingly utilized by large firms in the fintech area.

2. Legal Challenges Against the OCC Fintech Charter

The CSBS and the NYSDFS were early and vigorous opponents to the OCC fintech charter, going so far as to mount separate legal challenges against the charter. In challenging the OCC fintech charter, both the CSBS and the NYSDFS argued that the OCC’s decision to issue fintech charters exceeded its statutory authority under the National Bank Act (NBA).²⁰⁹ The CSBS filed two separate lawsuits in the United States District Court for the District of Columbia, while the NYSDFS lawsuit was filed in the United States District Court for the Southern District of New York. Both of the CSBS’s lawsuits were dismissed on the grounds that the CSBS lacked standing and its claims were unripe.²¹⁰ The NYSDFS, in contrast, was much

²⁰⁵ *Id.* at 5.

²⁰⁶ *Id.* at 10.

²⁰⁷ JD Alois, *After Years of Debate, Avant May Be the First to Receive an OCC Fintech Charter*, CROWDFUND INSIDER (Apr. 12, 2019, 3:57 PM), <https://www.crowdfundinsider.com/2019/04/146290-after-years-of-debate-avant-may-be-the-first-to-receive-an-occ-fintech-charter/> [<https://perma.cc/U9DR-PFY3>].

²⁰⁸ Mark Calvey, *Exclusive: Robinhood Seeks Regulatory Approval to Create a National Bank*, S.F. BUS. TIMES (Apr. 19, 2019), <https://www.bizjournals.com/sanfrancisco/news/2019/04/19/robinhood-fintech-bank-savings-checking-accounts.html> [<https://perma.cc/MLJ7-8HSS>].

²⁰⁹ See *Vullo v. Office of the Comptroller of the Currency*, 378 F. Supp. 3d 271, 280 (S.D.N.Y. 2019); *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, 313 F. Supp. 3d 285, 293 (D.D.C. 2018).

²¹⁰ *Conference of State Bank Supervisors*, 313 F. Supp. 3d at 296 (“CSBS fail[ed] to plead an injury that is ‘certainly impending’ or that exposes its members to a ‘substantial risk.’”); see also *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, No. 18-2449, 2019 U.S. Dist.

more successful in *Vullo v. Office of the Comptroller of the Currency*.²¹¹ In *Vullo*, the court held not only that the NYSDFS had standing and its claims were ripe, but also that the NBA “unambiguously requires that, absent a statutory provision to the contrary, only depository institutions are eligible to receive national bank charters from OCC.”²¹²

With now two differing positions on the ripeness of the lawsuits against the OCC, and the legal status of the fintech charter generally in question, the OCC has filed an appeal to the Second Circuit.²¹³ While the procedural issues related to standing and ripeness are clearly very relevant to the ongoing lawsuit against the OCC and its fintech charter, the focus of this subsection will be the substantive claims upon which the NYSDFS prevailed in its lawsuit.

The central legal issue in the dispute over the fintech charter is what constitutes the “business of banking.”²¹⁴ The OCC has consistently argued that the “business of banking” is ambiguous. The OCC provided its interpretation of the allegedly ambiguous term in 2003 when it promulgated a final rulemaking that amended 12 C.F.R. § 5.20(e)(1) “to require limited purpose national banks to conduct *at least one of the following core banking functions*: (1) Receiving deposits; (2) paying checks; or (3) lending money.”²¹⁵ In the final rulemaking, the OCC stated that “[t]he purpose of [the] proposed change was to clarify that a limited purpose national bank may exist with respect to activities other than fiduciary activities, provided the activities in question are part of the business of banking.”²¹⁶ Judge Marrero, who wrote the opinion in *Vullo*, disagreed with the OCC’s 2003 final rulemaking. In *Vullo*, he held that the “business of banking” is not ambiguous and clearly entails deposit taking.²¹⁷

The opinion by Judge Marrero offers an excellent outline of the arguments against the OCC in this case, as well as a thorough overview of many of the cases relevant to assessing the breadth of the OCC’s regulatory and chartering power. At the same time, however, there were two debatable arguments made within the opinion, both of which could likely be pressed by the OCC on its appeal. First, Judge Marrero quickly dismissed the holding in a much earlier

LEXIS 149531, at *1 (D.D.C. Sept. 3, 2019) (“The Court will grant the [OCC’s] motion to dismiss because CSBS continues to lack standing and its claims remain unripe.”).

²¹¹ 378 F. Supp. 3d at 271 (S.D.N.Y. 2019). Facing a motion to dismiss against three counts, the NYSDFS was allowed to proceed with two of the three. *Id.* at 278.

²¹² *Id.* at 298.

²¹³ Notice of Appeal, *Vullo*, 378 F. Supp. 3d 271 (No. 18-8377) [hereinafter *Vullo* Notice of Appeal].

²¹⁴ CSBS Complaint, *supra* note 124, at 4.

²¹⁵ Rules, Policies, and Procedures for Corporate Activities; Bank Activities and Operations; Real Estate Lending and Appraisals, 68 Fed. Reg. 70,122, 70,126 (Dec. 17, 2003) (to be codified at 12 C.F.R. pt. 5) (emphasis added).

²¹⁶ *Id.*

²¹⁷ *Vullo*, 378 F. Supp. 3d at 292 (“The Court finds that the term ‘business of banking,’ as used in the NBA, unambiguously requires receiving deposits as an aspect of the business.”).

case from the D.C. Circuit that addressed substantially the same issues. That case was *Independent Community Bankers Ass'n of South Dakota v. Board of Governors of the Federal Reserve System*,²¹⁸ and one of the central issues there was whether the OCC had the statutory authority to charter a “special purpose” national bank that would initially engage in only one enumerated banking power, namely consumer credit card lending.²¹⁹ In holding that the OCC *did* possess the power to charter this type of “special purpose” national bank, the court stated that “[t]here is nothing in the language or legislative history of the National Bank Act that indicates congressional intent that the authorized activities for nationally chartered banks be mandatory” and that the OCC may charter a national bank with restricted activities unless such restrictions would “undermine[] the safety and soundness of the bank or interfere[] with the bank’s ability to fulfill its statutory obligations.”²²⁰

As Judge Marrero noted in *Vullo*, courts in the Second Circuit are not bound by decisions from other circuits; therefore, he did not need to follow the D.C. Circuit’s holding in *Independent Community Bankers Ass’n*.²²¹ Judge Marrero further stated that, even if the D.C. Circuit’s reasoning on this point were correct, it still would not permit the OCC to charter nondepository institutions, as receiving deposits is a statutory obligation of national banks.²²² However, this interpretation of the D.C. Circuit’s language in *Independent Community Bankers Ass’n* is debatable. Unfortunately, it is unclear what the D.C. Circuit had in mind when it stated that restrictions on national bank activities should not undermine “the bank’s ability to fulfill its statutory obligations.”²²³ What seems clear, though, is that these “statutory obligations” do not include the enumerated powers of national banks like extending credit and receiving deposits as provided under the National Bank Act.²²⁴ This conclusion can partly be reached linguistically: an obligation is defined as a “legal or moral duty to do or not do something,”²²⁵ while a power is defined as the “ability” or “legal right” to act or not to act.²²⁶ Therefore, on this analysis,

²¹⁸ 820 F.2d 428 (D.C. Cir. 1987).

²¹⁹ *Id.* at 431, 439.

²²⁰ *Id.* at 440.

²²¹ *Vullo*, 378 F. Supp. 3d at 297 n.12.

²²² *Id.* at 297. In the same paragraph, Judge Marrero also seemed to indicate that *Independent Community Bankers Ass’n* is inapplicable because “in any event, it appears the banks at issue there did take deposits.” *Id.* However, as noted in the OCC’s reply brief in *Vullo*, “[T]he D.C. Circuit placed no weight on the fact, mentioned in passing, that the national bank intended to offer limited deposit-taking” Reply Memorandum of Law in Further Support of Defendants’ Motion to Dismiss the Complaint at 8, *Vullo*, 378 F. Supp. 3d 271 (No. 18-8377).

²²³ *Indep. Cmty. Bankers Ass’n*, 820 F.2d at 440.

²²⁴ See 12 U.S.C. § 24 (2018) (laying out the corporate powers of national banking associations).

²²⁵ *Obligation*, BLACK’S LAW DICTIONARY (11th ed. 2019).

²²⁶ *Power*, BLACK’S LAW DICTIONARY (11th ed. 2019).

though a national banking association may possess the legal right to receive deposits, it is under no legal duty to receive deposits.

The court's interpretation of *Independent Community Bankers Ass'n* is also inconsistent with the logic of the opinion. In *Vullo*, Judge Marrero wrote that "the proposition that deposit-receiving . . . is optional" does not follow from the holding in *Independent Community Bankers Ass'n*.²²⁷ However, this seems to be precisely what follows from the holding of *Independent Community Bankers Ass'n* because the issue in that case was whether the Comptroller of the Currency could issue a national charter to a bank that would initially only engage in consumer credit card lending.²²⁸ On that question, the D.C. Circuit answered "yes."²²⁹ What does seem clear is that the holding in *Vullo* and the holding in *Independent Community Bankers Ass'n* are in conflict. It remains open to debate which opinion reached the correct conclusion on the scope of the OCC's chartering authority.

The second argument that the OCC will likely press on appeal is that the court in *Vullo* gave too little weight to the holding in *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, a Supreme Court opinion that evaluated the phrase "incidental powers . . . necessary to carry on the business of banking" in the NBA and found it to be ambiguous.²³⁰ At issue in *NationsBank* was whether the OCC reasonably interpreted the term "incidental powers . . . necessary to carry on the business of banking" to allow national banks to sell annuities.²³¹ In holding that the term was ambiguous and that the OCC's interpretation was reasonable, the Supreme Court stated that

[i]t is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws.²³²

In its brief to the court in *Vullo*, the OCC noted that "*NationsBank* marked a watershed in construing the term 'business of banking' . . . by rejecting a narrow interpretation [of the statute], instead deferring to the 'expert financial judgment' of the Comptroller."²³³

²²⁷ *Vullo*, 378 F. Supp. 3d at 297.

²²⁸ *Indep. Cmty. Bankers Ass'n*, 820 F.2d at 439.

²²⁹ *Id.* at 440-41.

²³⁰ *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 256 (1995).

²³¹ *Id.*

²³² *Id.* at 256-57 (quoting *Clarke v. Sec. Indus. Ass'n*, 479 U.S. 388, 403-04 (1987)).

²³³ Memorandum of Law in Support of Defendants' Motion to Dismiss the Complaint at 14, *Vullo v. Office of the Comptroller of the Currency*, 378 F. Supp. 3d 271 (S.D.N.Y. 2019) (No. 18-8377).

The court in *Vullo*, however, found that *NationsBank* was not relevant to whether the OCC had the power to charter nondepository institutions. The court stated that *NationsBank* simply stands for the proposition that the outer bounds of what constitutes “the business of banking” is ambiguous.²³⁴ The court went on to note that “[i]t does not follow from the uncertainty surrounding the outer bounds of the term . . . that the threshold indispensability (or not) of deposit-receiving . . . is necessarily ambiguous.”²³⁵ Judge Marrero’s logic on this point seems reasonably sound. However, it arguably gives too little weight to the broad discretion the Supreme Court afforded to the Comptroller’s interpretation of the NBA. As argued by the OCC in its reply brief in *Vullo*, “Although *NationsBank* addressed the permissible limits of the term ‘business of banking’ ‘beyond those specifically enumerated,’ that context had no bearing on the Court’s granting deference to the Comptroller in interpreting this ambiguous term.”²³⁶

As previously noted, the OCC has appealed the decision in *Vullo*.²³⁷ The extent to which the Court should defer to the Comptroller in interpreting the NBA is still an open question, and one that will be central to the OCC’s appeal. The OCC’s decision to issue charters to nondepository fintech firms arguably pushes the outer boundaries of its authority under the NBA, as exemplified by the now-conflicting precedents in the D.C. and Second circuits. The ongoing litigation will continue to be closely watched by the financial services and fintech industries. This close attention reflects the significance of the OCC fintech charter. But of equal importance, given the steep cost of pursuing a national bank charter and the risk that such a charter may be held to be invalid, many fintech firms may be dissuaded from pursuing a charter until these questions are resolved.

3. Policy Challenges to the OCC Fintech Charter

The CSBS in its separate lawsuit also asserted several policy-based critiques of the OCC fintech charter. The CSBS has argued that the OCC “charter lacks transparency, will preempt important state consumer protections, and will slow business innovation by advantaging larger players over small firms.”²³⁸ In support of these policy arguments, the CSBS contends that the OCC’s decision to extend preemption of state antipredatory lending

²³⁴ *Vullo*, 378 F. Supp. 3d at 297-98.

²³⁵ *Id.* at 298.

²³⁶ Reply Memorandum of Law in Further Support of Defendants’ Motion to Dismiss the Complaint at 8, *Vullo*, 378 F. Supp. 3d 271 (No. 18-8377) (citation omitted).

²³⁷ *Vullo* Notice of Appeal, *supra* note 213.

²³⁸ John W. Ryan, *The OCC Fintech Charter*, CONF. ST. BANKING SUPERVISORS (June 1, 2017), <https://www.csbs.org/occ-fintech-charter> [<https://perma.cc/8FSC-PG4J>].

laws to nondepository mortgage subsidiaries of national banks laid “the legal foundation for the subprime lending abuses that bore out during the financial crisis.”²³⁹ The CSBS argues that the Dodd–Frank Act was enacted in part to limit the OCC’s authority to preempt state consumer protection laws.²⁴⁰ The CSBS concludes by arguing that state regulators are best situated to regulate these nonbank entities and foster innovation.²⁴¹

The CSBS’s policy-based claims against the OCC fintech charter are suspect on several fronts. The CSBS is correct to criticize the role that the OCC and the now-defunct Office of Thrift Supervision played in failing to intervene in the increasingly dangerous subprime mortgage market leading up to the financial crisis. However, it can hardly be contended that state regulators were not equally complicit. State regulators largely acquiesced to lobbying by state-chartered banks to either not regulate subprime loans originated by these institutions at all or to waive antipredatory laws over subprime loans.²⁴² Furthermore, the complaint by the CSBS acknowledges that the Dodd–Frank Act “limit[ed] the OCC’s authority to preempt state consumer financial laws . . . through the imposition of new procedural and evidentiary requirements and heightened standards of review.”²⁴³ The risk of any gaps in consumer protection laws that could be created by preemption of state law is also clearly remedied by one of the main pillars of the Dodd–Frank Act: the CFPB. P2P lenders and other fintech firms, like all participants in the financial industry, are subject to rules promulgated by the CFPB pursuant to its rulemaking authority.²⁴⁴ And the CFPB, if it sees fit in the future, could assert its authority to supervise and examine P2P lenders and other firms if it determines that these firms are a “larger participant of a market for other consumer financial products or services.”²⁴⁵ Overall, the legislative reforms put into place under the Dodd–Frank Act should more than mitigate the past deficiencies that the CSBS focuses on in its complaint.

4. Fintech Chartering—A Twenty-First Century Solution

Fintech chartering is the best available regulatory approach for P2P lenders. Chartering will benefit consumers by ensuring a uniform regulatory

²³⁹ CSBS Complaint, *supra* note 124, at 15.

²⁴⁰ *Id.* at 16.

²⁴¹ *Id.*

²⁴² Kathleen C. Engel & Patricia A. McCoy, *Federal Preemption and Consumer Financial Protection: Past and Future*, 31 BANKING & FIN. SERVICES POL’Y REP. 25, 30 (2012).

²⁴³ CSBS Complaint, *supra* note 124, at 16 (citing 12 U.S.C. § 25b(b)–(d), (g) (2018)).

²⁴⁴ 12 U.S.C. § 5512 (2018).

²⁴⁵ *Id.* § 5514(a)(1)(B). Notably, because the OCC fintech charter does not require charter applicants to take deposits or obtain deposit insurance, the CFPB could not exercise its supervisory powers under § 5515, as that section only applies to large *insured depository* institutions.

approach to these lenders and consistent application and enforcement of the federal consumer protection laws. Furthermore, federal preemption will reduce the burden of complying with the hodgepodge of complex state laws. Regulators benefit from chartering, since it allows them to develop a functional approach to fintech firms and gain greater insight on the benefits and risks of these firms. Finally, looking forward, chartering for fintech companies broadly, including P2P lenders, reduces the potential that excess risk will build up in this largely unsupervised area of the financial sector.

The focus of this Comment has been consumer protection in P2P lending. While a national fintech charter may present some consumer protection risks,²⁴⁶ it remains the best available option for ensuring consumer protection in P2P lending. Chartering P2P lenders will produce two broad benefits for consumers. First, national chartering will ensure that *all* consumers in the United States are afforded the same degree of protection under consumer protection laws. The current state-based regulator approach does not provide parity. Some states, like California and New York, have been aggressive in enforcing consumer protection laws.²⁴⁷ At the same time, other states like Arizona have opted to abdicate enforcement of these laws entirely.²⁴⁸ Nationwide supervision and enforcement by the OCC would mitigate this problem and ensure that all consumers receive the same degree of protection regardless of their state of residence.

Second, violations of consumer protection laws will be identified and mitigated earlier under a regulatory regime that involves fintech chartering. Under the current system of regulating fintech firms, violations of consumer protection laws are largely addressed through enforcement actions pursued by state attorneys general or federal agencies. This manner of enforcement is incredibly inefficient and typically only arises when a great degree of consumer harm has already occurred. Under a chartering system, chartered fintech firms would be subject to routine examination by prudential bank regulators. These examinations would provide a key means to identify and stop potentially harmful practices early.

The benefits that will accrue to consumers through chartering are obviously contingent on P2P lenders (and other fintech firms) actually taking advantage of the charter. There are reasons to believe that chartering will be appealing to P2P lenders. First, and likely most importantly, a national bank

²⁴⁶ See *supra* notes 209–217 and accompanying text (discussing the NYSDFS's and CSBS's legal arguments against the OCC fintech charter); notes 238–245 and accompanying text (discussing the CSBS's policy arguments against the OCC fintech charter).

²⁴⁷ FRANSON & MANBECK, *supra* note 69, at 19–21 (discussing the generally aggressive approach of California and New York regulators toward fintech firms).

²⁴⁸ See *supra* notes 125–129 and accompanying text (discussing Arizona's regulatory sandbox for fintech firms).

charter preempts state laws over licensing and supervision.²⁴⁹ This will save P2P lenders the costs associated with complying with a myriad of differing state regulatory regimes, as well as the risk of noncompliance with these varying state laws. Second, a special purpose national bank charter will likely provide P2P lenders with access to the Federal Reserve discount window and the U.S. payments system.²⁵⁰ Access to the discount window would allow P2P lenders to obtain low-cost funding in the event of a short-term liquidity crunch. Access to the payments system would lower transaction costs for P2P lenders. Third, obtaining a special purpose national bank charter now would simplify the process of obtaining federal deposit insurance in the event that a P2P lender decides to become a full-service banking organization. While the business model of P2P lending in theory involves investors ultimately funding loans made on the platform, LendingClub and Prosper are increasingly holding a significant portion of loans originated through the platform and utilizing borrowings to fund these assets.²⁵¹ Insured deposits would provide a lower-cost form of funding and could be appealing to P2P lenders as their business model evolves. It appears that all three of these factors were major considerations in LendingClub's recent decision to pursue an acquisition of a federally chartered bank.²⁵²

²⁴⁹ See, e.g., 12 U.S.C. § 484 (2018) (preempting national banks from examination by state regulators); 12 C.F.R. § 7.4000 (2019) (same); 12 U.S.C. § 25b (preempting national banks from state laws regarding loan terms, interest rates, disclosure, and other laws); 12 C.F.R. §§ 7.4007–7.4008 (same); see also DAVIS POLK, BEYOND FINTECH: THE OCC'S SPECIAL PURPOSE NATIONAL BANK CHARTER 2 (2016), https://www.davispolk.com/files/2016-12-9_occs_special_purpose_national_bank_charter.pdf [<https://perma.cc/S97Q-PRM5>] (“In general, pursuant to preemption regulations issued by the OCC implementing Sections 1044–1046 of the Dodd–Frank Act, state laws or requirements are preempted when they conflict with the exercise by a national bank of its federally granted powers.” (citations omitted)).

²⁵⁰ There is some debate as to whether the Federal Reserve would provide fintech firms with special purpose national bank charters access to these services. See Rachel Witkowski, *Fed Will Have the Say on Key Parts of OCC's Fintech Charter*, AM. BANKER (Sept. 18, 2018), <https://www.americanbanker.com/news/fed-will-have-the-say-on-key-parts-of-occs-fintech-charter> [<https://perma.cc/7VGU-JGJS>]; see also DAVIS POLK, *supra* note 249, at 8 (discussing the Federal Reserve's historical skepticism of “commercial companies controlling banking organizations.”).

²⁵¹ LendingClub 10-K, *supra* note 18, at 135–37 (showing that as of December 31, 2018, LendingClub had the following debt obligations associated with its operations: warehouse borrowings of \$338.9 million; revolving debt of \$95 million; repurchase agreements of \$57 million; securitization notes held by third parties and classified as debt totaling \$256.2 million; and \$81.1 million in secured borrowings); Prosper 10-K, *supra* note 18, at F-30 (indicating that as of December 31, 2018, Prosper had total debt of \$162.5 million). Prosper also noted in a 2019 press release that it has “significantly diversified [its] funding sources through new institutional and bank investors on [its] platform, \$500 million of committed warehouse facilities” and its securitization program. *Prosper Reports Full Year 2018 Financial Results*, PROSPER (Mar. 29, 2019), <https://www.prosper.com/about-us/media/2019/03/29/prosper-reports-full-year-2018-financial-results/> [<https://perma.cc/H4SC-EVJK>].

²⁵² See Press Release, LendingClub, *supra* note 8 (stating that the proposed acquisition would enhance LendingClub's resilience by offering low-cost insured deposits and deliver regulatory clarity).

An OCC fintech charter also allows federal regulators to become more familiar with this new generation of financial service providers and tailor its regulatory approach to the particular risks presented by each firm. William Warren, utilizing a framework developed by Professor Steven Schwarcz, has argued that regulators should take a functional approach to regulating the P2P lending market and adapt their approach to the unique risks of these lenders.²⁵³ As the OCC has made clear, “The scope of supervision activities will follow a risk-based approach commensurate with the size and complexity of the institution, focusing on any elevated risks and unique supervisory challenges presented by a [special purpose national bank].”²⁵⁴ Inherent in this approach is tailoring supervision of fintech firms to the unique risks posed by those firms. Expanding supervision also means that OCC examiners will be present at these institutions, allowing for greater data collection and risk assessment.

Finally, chartering may help prevent, or at the very least reduce the impact of, a financial crisis stemming from fintech companies. While this Comment has focused on consumer protection risks rather than systemic ones, it is worthwhile touching on the potential systemic risks presented by fintech. William Magnuson has outlined three acute problems posed by fintech firms from a systemic risk perspective:

First, fintech firms, because of their size and business model, are more vulnerable to adverse economic shocks than large financial institutions, and those shocks are more likely to spread to other firms in the industry. Second, fintech firms are more difficult to monitor and constrain than typical financial institutions because regulators lack reliable information about the structure and operations of fintech markets. Third, fintech markets suffer from collective action problems that inhibit cooperation among market actors.²⁵⁵

A special purpose national bank charter for fintech firms would be particularly useful in addressing each of these potential risks. Chartered fintech firms, like regular national banks, would “be subject to the minimum leverage and risk-based capital requirements in 12 C.F.R. § 3 that apply to all national banks.”²⁵⁶ Capital requirements should help harden fintech firms to such adverse economic shocks. Additionally, examinations by prudential regulators should provide a means to spot potentially risky interconnectedness between fintech firms before these risks blow up into a crisis. These examinations will also mitigate the second risks identified by Magnuson, as regulators will be well-positioned to monitor those fintech firms that pursue

²⁵³ Warren, *supra* note 9, at 312-15.

²⁵⁴ COMPTROLLER'S LICENSING MANUAL SUPPLEMENT, *supra* note 203, at 14.

²⁵⁵ William Magnuson, *Regulating Fintech*, 71 VAND. L. REV. 1167, 1171-72 (2018).

²⁵⁶ COMPTROLLER'S LICENSING MANUAL SUPPLEMENT, *supra* note 203, at 8.

chartering. Finally, the greater role of regulators in this space would undoubtedly help mitigate collective action problems. Through chartering, regulators will be better positioned as a centralized player among all chartered fintech firms, allowing them to marshal resources and push collective action in the event of a crisis.

CONCLUSION

P2P lending has transformed over the course of the twenty-first century, and the regulatory structure around it must also transform. Consumers have benefited from P2P lending in the form of increased access to credit and possibly lower rates of borrowing. However, this area of lending presents unique risks in the form of alternative data. Furthermore, as P2P lending increasingly becomes dominated by traditional financial intermediaries like banks and institutional investors, arguments that this new technology must be protected and fostered become increasingly attenuated. Rather, the primary concern for regulators today should be the consumer protection risks attendant to P2P lending. As this Comment has argued, the current regulatory regime around P2P lending is ineffective: securities regulation does nothing to protect consumers, regulation under the Bank Service Company Act is too opaque, and a state-based approach faces severe collective action problems. Fortunately, a regulatory approach focused on chartering P2P lenders addresses many of these issues. A special purpose national bank charter will ensure greater supervision of P2P lenders but also provide sufficient incentives, in the form of state-law preemption, to appeal to these lenders. Additionally, chartering will produce secondary benefits by bringing these institutions out of the “shadow banking” world, allowing for greater regulatory knowledge of these entities and reducing systemic risk. Ultimately, chartering is the best way to allow P2P lenders to continue their impressive growth in a manner that ensures compliance with consumer protection laws.

* * * * *